

The New York Certified Public Accountant



Vol. XI

November • 1940

No. 2

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Published by

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
15 E. 41st STREET . NEW YORK

Managing Editor

WENTWORTH F. GANTT

The NEW YORK CERTIFIED PUBLIC ACCOUNTANT is published monthly from October to June. Copies may be obtained at the office of the Society at twenty-five cents per copy, \$2.00 per year. All other communications relating to this publication should be addressed to the Committee on Publications.

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THE NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

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STATE SOCIETY ACTIVITIES

Calendar of Events

November 6—8 P.M. Special Technical Meeting. Subject: Monthly Audits. Location: Engineering Auditorium, 29 W. 39th Street, New York City.

November 13—8 P.M. Special Technical Meeting. Subject: Municipal and Local Taxation. Location: Engineering Auditorium, 29 W. 39th Street, New York City.

November 14—Regular Meeting of the Board of Directors.

November 18—7:45 P.M. Society Meeting. Subject: Federal Taxation. Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

November 19—7:45 P.M. Society Meeting. Subject: Federal Taxation. Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

December 5—Regular Meeting of the Board of Directors.

December 9—7:45 P.M. Society Meeting. Subject: State Taxation. Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

November Tax Meetings

On the evenings of November 18th and 19th, at the Waldorf Astoria Hotel, the Fall tax meetings of the Society will take place under the auspices of the Federal Taxation Committee, of which Nicholas Salvatore is Chairman. The program will be as follows:

Monday, November 18, 1940—Grand Ballroom—Subject: Federal Taxation

"Summary of the First and Second Revenue Acts of 1940 with Par-

ticular Reference to the Excess-Profits Tax Imposed under the Second Revenue Act of 1940"

By Dr. Joseph J. Klein, C.P.A.

"Excess-Profits Tax Imposed by the Second Revenue Act of 1940; Excess-Profits Net Income and Excess-Profits Credit Based on Income"

By Walter A. Cooper, C.P.A.

"Invested Capital and Excess-Profits Credit Based on Invested Capital"

By William LeRoy Ashbaugh, C.P.A.

"Special Provisions Including Consolidated Returns and Rules in Connection with Certain Exchanges"

By J. S. Seidman, C.P.A.

Tuesday, November 19, 1940—Starlight Roof—Subject: Federal Taxation

"Tax Problems to Be Considered before the End of the Taxable Year"

By Andrew B. Trudgian, attorney at law

"Determination of Earnings and Profits of Corporations"

By George E. Cleary, attorney at law

Accountants and Credit Men's Meeting

At a dinner held in the Perroquet Suite of the Waldorf Astoria Hotel on October 23rd, the Society's Committee on Cooperation with Credit Men was host to the Committee on Cooperation with Certified Public Accountants of the New York Credit Men's Association as recently appointed by Clarence L. Riegel, President of the Association. This new committee is composed of credit representatives from many diversified industries, and was

formed for the purpose of establishing a long range program of cooperation between the accounting profession and credit men in industries additional to the textile and related trades. This cooperation is to be similar to that developed during the past year between this same committee of the Society and the Association's Committee on Accountants' Certificates, of which Mr. Samuel Bertcher is Chairman.

The meeting was opened with an address by Simon Loeb, Chairman of the Society's Committee, in which he stated that the primary purpose before the two groups was to weigh the problems which credit men in these diversified industries are confronted with in granting credit, and to make clear the aid which the independent certified public accountant can render.

Mr. Samuel Bertcher, who is also Chairman of the Association's new Committee, then described the steps by which his Committee on Accountants' Certificates had been cooperating during the past year with the Society in making a study of supplementary information to be furnished by certified public accountants with respect to statements submitted for credit purposes. Mr. Bertcher stated that in order to effectuate plans for future deliberations between the two committees present, a sub-committee from each will be appointed by their respective chairmen in order to prepare a program of objectives.

Mr. James F. Hughes, Vice Chairman of the Society's Committee, then addressed the meeting and complimented Messrs. Loeb & Bertcher upon the work they had already accomplished. He assured the credit men present that the accounting profession appreciated the importance of the continuation of these cooperative efforts, and envisioned beneficial results for all concerned. President Riegel, of the Credit Men's Association, stressed the importance of this

meeting and hoped that the efficient use of audited figures now enjoyed by the textile industry would be extended to other fields.

Mr. Fedde, President of the Society, then spoke in appreciation of the friendliness and spirit of tolerance which now existed between the two associations, and made a plea for a continuance of this same feeling. Following Mr. Fedde, Mr. John L. Redmond, President of the National Association of Credit Men, clarified the attitude of the credit man toward the accountant, and Mr. William W. Orr, Secretary of the Credit Men's Association, spoke on the practical aspects of cooperation, and the benefits which have already accrued to both professions as a result.

The latter part of the meeting was taken up with brief statements by certain of the credit men present with respect to the credit problems in their different industries, and the importance of certified financial statements to each. The consensus of opinion was that the excellent cooperative results produced for the textile and related trades could well be placed at the disposal of all industries, and the program received the enthusiastic approval of all present.

The meeting was closed by Mr. Wm. C. Heaton, member of the Society's committee, with a plea for continued friendship and cooperation between credit men and certified public accountants.

Rochester Technical Conference

On October 25, 1940, the first Fall Technical Conference sponsored by the four upstate chapters of the Society was held at the Hotel Seneca in Rochester, N. Y. The Conference was divided into morning, afternoon, and evening sessions, at which were presented a number of interesting papers on improvement in reportorial

State Society Activities

content of statements for clients, fundamental audit practice, and general problems of the profession.

The proceedings were well attended by approximately 85 members from Buffalo, Rochester and Syracuse, as well as Mr. A. S. Fedde, President, Mr. Andrew Stewart, First Vice-President, Mr. Wentworth F. Gantt, Assistant to the President, and Mr. Joseph W. Welsh, Jr., of the Society's staff, from New York City. The Conference was under the general direction of a Central Committee composed of Ralph S. Good of Rochester, General Chairman, James L. Strong of Buffalo, and Prof. George E. Bennett of Syracuse, Vice-Chairman. A welcome was extended to the members present by the Mayor of Rochester, the Hon. Samuel B. Dicker, at a luncheon meeting held after the morning session, followed by addresses of Mr. Fedde and Herman A. Miller, President of the Rochester Chapter.

Some very interesting discussion developed after the presentation of papers at each session, which provided an excellent opportunity for upstate members of the Society to get together and exchange viewpoints. The Conference was unanimously voted a success by all those present, and the hope was expressed that another similar meeting be arranged for next year.

Below are given the subjects to which these sessions were devoted, and the speakers who participated in the program:

Morning Session

General Subject:

Improvement in Reportorial Content

- (a) Statements for Clients' Employees
Speaker—Professor George E. Bennett, C.P.A. Syracuse, N. Y.
- (b) Extent of Statistical Data in Accountant's Report

Speaker—Geo. T. Hubbell, C.P.A., Buffalo, N. Y.

(c) Interim Reports

Speaker—Rupert G. Fain, C.P.A., Rochester, N. Y.

Afternoon Session

General Subject:

Fundamental Audit Practice

- (a) Direction, Supervision and Review

Speaker—Benjamin L. Enloe, C.P.A., Buffalo, N. Y.

- (b) Methods, Development and Extension of Internal Audit and Control

Speaker—James L. Rothwell, C.P.A., Rochester, N. Y.

- (c) Audit Costs and Limitations

Speaker—Wendell N. Butler, C.P.A., Syracuse, N. Y.

Evening Session

General Subject:

Professional Problems

- (a) Responsibility and Co-operation of the C.P.A. in Education and Training of Accountancy Students.

Speaker—Frederick A. Wagner, C.P.A., Buffalo, N. Y.

- (b) Selection of Employees Entering Public Accounting.

Speaker—Herman A. Miller, C.P.A., Rochester, N. Y.

- (c) Increased Service to Present Clients.

Speaker — Charles F. Carr, C.P.A., Syracuse, N. Y.

American Institute Elections

At the annual meeting of the American Institute of Accountants held on October 13-18 in Memphis, Tenn., the following members of this Society were honored by being elected officers of that organization for the ensuing year:

The New York Certified Public Accountant

C. Oliver Wellington.....President
Maurice E. Peloubet...Vice-President
Samuel J. Broad.....Treasurer
Martin Kortjohn}Auditors
Simon Loeb }

Victor H. Stempf, immediate past president and now a director of the Society, and Norman E. Webster, were elected as members of the Council of the Institute for a term of three years.

American Red Cross

An announcement has been received from the New York Chapter of the American Red Cross to the effect that Gordon M. Hill, a member of the Society, has been appointed Chairman of the Accountants Group in the 1940 membership roll call of the New York Chapter.

Mr. Hill has called for the cooperation of accountants in the campaign for raising funds for the Red Cross

to be conducted from November 11th to 23rd.

Paul L. Loewenwarter

Paul L. Loewenwarter, a valued and esteemed member since August, 1912, passed away on October 15, 1940, after a long illness, at the age of 77.

Mr. Loewenwarter served as a Director of the Society from 1928-1929, and was active on various committees.

He is survived by his widow, a son and a daughter.

In his passing, the Society as well as the accountancy profession at large, has sustained the loss of an able and loyal member whose long record of devotion to the profession has contributed much and has exerted an influence which will long survive him.

PROFESSIONAL COMMENT

Wages and Hours

On October 29, 1940, a notice was sent to the membership of the Society describing the recently amended regulations pertaining to Section 13 (a) of the Fair Labor Standards Act. These amendments became effective on October 24, 1940, and contain new definitions and limitations with respect to executive, administrative and professional groups which are of particular interest to accountants.

The Society cannot undertake to advise on the many problems arising under the law and the new regulations, since to do so would involve the giving of legal advice. The U. S. Department of Labor has issued a series of Interpretive Bulletins relating to the general application of the law which answer most of the questions being asked of the Society. Interpretive Bulletin No. 4 more particularly touches on the application of the law to salaried employees. There has also been recently published the Report and Recommendations of the presiding officer at hearings held preliminary to a redefinition of the terms "executive, administrative, professional and outside salesman". Bulletin No. 4 and the text of the hearings referred to can be obtained from the U. S. Department of Labor or the Government Printing Office in Washington, D. C.

If the provisions of this law affecting accountants should become further clarified by judicial decision or regulation, members will be so advised.

Accountants' Liability Insurance

A request was recently received by the Society for information as to whether accountants' liability insur-

ance can now be obtained with provision for a refund of part of the premium sur-charge for Securities Act coverage if the insured does not have more than two registration statements during the policy year. Information was also requested as to a form of policy in which there is no sur-charge if the insured files no registration statements, or if work is limited to Form 10-K.

These questions were submitted to Mr. E. J. Buehler, Chairman of the Society's Committee on Auditors' Liability, who has offered the following comments:

"With reference to this inquiry I am informed by one insurance company that they do not make any refund of the sur-charge for the securities act if the insured has no registration statements during the policy year. I am further informed that their policy automatically covers without sur-charge if the insured files no registration statements, the work being limited to Form 10K.

"Another company tells me that if there is no work performed under the Securities Act they will refund 50% of the sur-charge, but that if any work at all under such act be performed, they will make no refund. Their policy also automatically covers without sur-charge, in the event the insured files no registration statements, his work being limited to Form 10K.

"Might I add that an accountant's liability policy may give coverage against claims made during the policy year. Therefore, should an accountant have a registration statement this year (and take out insurance coverage thereon) but have no such statement

next year, it may nevertheless be wise for him to consider such coverage until his term of liability expires."

Accountants and the Investment Advisers Act

In Release No. 1, issued September 23, 1940 by the Securities and Exchange Commission under the Investment Company Act of 1940, it is stated that individuals whose investment advice is only incidental to their profession do not come under the provisions of this Act. Accountants are specifically described as being excluded from its authority in the following paragraph taken from the release:

"The act, however, does not encompass newspapers, magazines and financial publications of general and regular circulation, or brokers and security dealers whose investment advice is given solely as an incident of their regular business for which no special fee is charged. The act also excludes banks, certain bank holding-company affiliates, individuals or organizations which act as investment advisers solely for investment and insurance companies, and lawyers, *accountants*, engineers, and teachers whose investment advice, if any, is solely incidental to the practice of their professions."

Amendment to Personal Property Law

On April 13, 1940 an amendment to the Personal Property Law was made effective under the heading of Chapter 452 of the Laws of New York—1940. This new Chapter amends the existing law by adding a new section known as 17-c, dealing with the administration of real property acquired by a fiduciary through foreclosure or in lieu of foreclosure of mortgage investments.

The object of this bill is to abolish the Chapal-Otis rules in connection with foreclosed real estate held by fiduciaries for any transactions after its passage, and to modify these rules for old foreclosures. For the benefit of those members of the Society who may be interested in the provisions and purposes of this new amendment, Chester A. Allen, member of the Committee on Fiduciary Accounting, has prepared the following summary and explanation:

With respect to trusts created or coming into being and mortgage investments made after April 13, 1940, the first subdivision of this new section of the Personal Property Law does away with the salvaging requirements of the Chapal-Otis cases, with their consequent complicated apportionment between principal and income. By its terms, the second subdivision of this new section modifies the old rules as to foreclosures already in existence (exclusive of property resold before the passage of the statute), and as to foreclosures which may occur, whether started before or after April 13, 1940, in connection with mortgage investments made before the passage of the statute.

The first subdivision of section 17-c abolishes the existing complicated rules for salvaging and eventual apportionment as set out in the matter of Chapal (269 N. Y. 464), and in the matter of Otis (276 N. Y. 101). In the cases covered by the first subdivision, the acquisition of real property by foreclosure is to be treated as though the real property was purchased as a proper trust investment. Net rents will be payable to the life tenant, and presumably net deficits in operation will be deductible from other income of the trust. The proceeds of sale, whether at a profit or loss, will all belong to corpus.

The second subdivision of section 17-c continues the rule of the Chapal-Otis cases, but modified so as to permit the Trustee to pay to the life tenant net rents received on foreclosed properties up to 3% of the face of the mortgage foreclosed. If less than 3% is received in a year, the whole net is payable to the life tenant. If more than 3% is received, the surplus is applied to the advances made from principal.

There is question as to the validity of the second subdivision of this new legislation as impairing the rights of remaindermen which *surely* attached at the date of acquisition as to real estate foreclosed prior to the passage of the act, and which may be *claimed* to have attached in connection with foreclosure of mortgages held prior to the passage of the act, although foreclosure was completed after passage. Until settled by the decisions of our Courts, prudent trustees will probably continue to impound net rents so as to have them available for payment to life tenant or for continued holding for remaindermen, whichever way the law may eventually be interpreted.

This brief summary does not attempt to go into details of many questions which will undoubtedly be raised by individual situations:

- (a) Is it sure that losses in operation of foreclosed real estate will be deducted from income otherwise payable to life tenant?
- (b) What would the rule be if the other income in a given trust was insufficient to meet the loss in operation of foreclosed real estate? In some cases there might be no other income.
- (c) Will the general rules as to charging principal with carrying charges of unimproved and unproductive real estate properly held in a trust and then apportioning the ultimate sales of such real estate, apply to unimproved and unproductive real estate acquired by foreclosure?
- (d) What will be the effect upon fiduciaries' judgment in paying of taxes out of income where foreclosed property reaches a point where it should be abandoned?

A comment by Surrogate James A. Foley of New York County, as published in the New York State Bar Association Bulletin of June, 1940, concludes that the 3% payment is an annual charge, so that income from good years shall not be applicable to deficits in bad years; that the anniversary date in the computations shall be the date of acquisition of each foreclosed property, so that the Trustee will have a separate calculation as to each foreclosed property in his account. It would also seem certain that each foreclosed property is to be treated by itself, so that income from a property showing a return does not have to be reduced by losses in operation of other foreclosed properties.

The purpose of the Statute itself is declared to be a simplification of the rules of procedure in mortgage salvage operations. Regardless of the present question of constitutionality in the retroactive provisions of the second subdivision of the new law, eventually, as noted by Surrogate Foley in his article referred to above, the passage of time will make operative only the simple rules set forth in the first subdivision. A second purpose of the statute is declared to be the elimination of present complications which work to the disadvantage of the life tenant, who is surely the principal object of the

testator's or settlor's bounty. The Chapal-Otis decisions gave trustees permission to make payments to life tenants during the course of administration of foreclosed real property, but any such payments made were at the risk of the fiduciary in the event that final calculation showed that the life tenant had been overpaid. Consequently, the discretionary power to make these payments was rarely exercised. Approval of the new statute by Court decisions will go a long way towards removing this hesitancy, and life tenants will then be benefited in all cases where foreclosed real property is operated at an annual profit. Immediate benefit will be given to life tenants in cases arising under the first subdivision, where the foreclosed real property is operated at an annual profit.

Relations between Controllers and Public Accountants

Certified Public Accountants will undoubtedly be interested in a paper printed in the September 1940 issue of *THE CONTROLLER*. This paper, entitled "Relations between Controllers and Public Accountants", was written by Mr. Ralph T. Millet, an undergraduate in the Department of Business and Engineering Administration of the Massachusetts Institute of Technology. It was one of two prize winning essays on this subject in a contest conducted by the Controllers Institute of America.

Mr. Millet, in his summation, concludes that there are three main points at which the responsibilities of controllers and public accountants merge and where natural cooperation should be expected:

- 1—A close cooperation in matters of internal control. This will make for more effective controlling systems and will allow the public accountant to carry on the auditing more effectively.
- 2—The financial reports can be a field of joint endeavor for the controller and independent public accountant. The presentation of the report is made by the controller. The certification of the report is made by the public accountant.
- 3—The accounting policies and system of the company should be subject to continual check both by the controller and the public accountant. A close relationship should exist between the officers in solving problems of an accounting nature.

In commenting on this essay, the editors of *THE CONTROLLER* state that there may not be complete agreement on one thought advanced by the author, which is, namely, that a controller should have had public accounting experience. Many successful controllers, they point out, have never had such experience and will object to too much emphasis being placed upon the accounting phase of their duties and responsibilities.

ELECTIONS

The following is a list of applicants admitted to membership and associate membership in the Society and also associate members advanced to membership at a meeting of the Board of Directors held on October 4, 1940:

Membership

Bierschenk, Joseph E., 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Bingham, William Theodore, 1 Cedar Street,
With Arthur Young & Company.
Brown, Benjamin, 395 Broadway.
Easton, Louis, 8 W. 40th Street,
Of Easton and Jerchow.
Goldstein, Irwin, 344 W. 37th Street.
Greenberg, Joseph S., 291 Broadway.
Hutchinson, J. Gordon, 56 Pine Street,
With Price, Waterhouse & Co.
Ives, George Reuben, 616 Marine Midland
Bldg., Binghamton,
Of Horton and Ives.
Lust, Alfred Max, 175 Fifth Avenue,
Of Alfred M. Lust & Company.
Magon, Bernard, 154 Nassau Street.
Mullen, Charles, 56 Pine Street,
With Price, Waterhouse & Co.
Murphy, Howard Dudley, 56 Pine Street,
With Price, Waterhouse & Co.
Rankin, John Gesner, 67 Broad Street,
With Haskins & Sells.
Riley, Carroll Delay, 341 Ninth Avenue,
With U. S. Treasury Dept., Income Tax
Unit.
Rudden, Peter Terence, 22 E. 40th Street,
With Haskins & Sells.
Sair, Conrad Marion, 55 Liberty Street.
Schneider, Emil Ludwig, 565 Fifth Avenue.
Schultz, Sidney, 1440 Broadway.
Schwartz, Emanuel M., 570 Seventh Avenue,
Of Gleiber and Schwartz.
Seidman, Victor L., 358 Fifth Avenue,
With Alson & Brown.
Smith, Otis K., 80 Maiden Lane,
With Touche, Niven & Co.
Stackel, Julius, 12 E. 41st Street.
Stevens, Edwin H., 27 Clinton Avenue,
South, Rochester.
Wallace, James Lawrence, 22 E. 40th Street,
With Haskins & Sells.
Wiendieck, Clifford William, 69 Dey Street,
With Richards & Ganly.
Youngdahl, Curtis Emerson, 67 Broad Street,
With Haskins & Sells.

Associate Membership

Ackermann, Frederic Boyd, 56 Pine Street,
With Price, Waterhouse & Co.
Barnes, Carl Robert, State College, Pa.,
With Pennsylvania State College.

Battisti, Albert D., 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Bini, Benedict, 152 W. 42nd Street,
Assistant Controller, Terminal Barber
Shops, Inc.
Blum, Seymour Edward, 1501 Broadway,
With Louis Sturz & Co.
Brand, Samuel Stanley, 354 Fourth Avenue,
With Lerner Stores Corporation.
Breiner, Edmund E., 115 Broadway,
Asst. Sec., Trust Company of North
America.
Casselman, Francis Abbott, 230 Park Avenue,
With Frazer and Torbet.
Deutsch, Eugene A., 1441 Broadway,
Of Hyans, Stern & Company.
Dowd, Thomas G., 605 W. 132nd Street,
With Gray Line Motor Tours, Inc.
Enroth, Carl Edward, 111 Broadway,
With Scovell, Wellington & Company.
Farrell, Leonard J., 30 Rockefeller Plaza,
Asst. Treas., Pathe Laboratories, Inc.
Freeman, Marcel Maurice, 60 E. 196th Street.
Gertz, Irwin, 110 E. 42nd Street,
With Morris A. Guttelman.
Goodwin, James J., East Rochester,
With Despatch Shops, Inc.
Greenberg, Nathan A., 50 E. 42nd Street,
With David S. Pollock.
Gross, Martin D., 19 W. 44th Street,
With Singer and Finke.
Hartigan, Matthew Arthur, 140 Broadway,
With Guaranty Trust Company of N. Y.
Handman, Sidney, 1440 Broadway,
With Schwartz & Holtz.
Helfman, Irving L., 19 W. 44th Street,
With Margold, Erskine & Wang.
Hennessy, Franklin Joseph, 500 Fifth Avenue,
With McCormack Transit-Mix Concrete
Company, Inc.
Imbese, Domenic J., 30 Rockefeller Plaza,
With Colonial Sand & Stone Co., Inc.
Kivelewitz, Paul, 252 Main Street,
Norwich, Conn.,
With Beit Bros., Incorporated.
Lewis, Aaron I., 320 Fifth Avenue,
With Osterweil, Oshrin & Gruhn.
Lyons, H. Robert, 40 Worth Street,
With Joshua L. Baily & Co.
McIntyre, Paul Francis, 290 Broadway,
With Dun & Bradstreet, Inc.
Mintzer, Harry, 521 Fifth Avenue,
With Eisner & Lubin.
Naramore, Harold Burling, 30 Broad Street,
With R. G. Rankin & Co.

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Neumann, William, 40 Rector Street,
With West, Flint & Co.
Pickup, Dana Roland, 1720 Rand Bldg.,
Buffalo,
With Price, Waterhouse & Co.
Rashkin, Benjamin, 521 Fifth Avenue,
With Eisner & Lubin.
Reich, Joseph E., 25 W. 32nd Street,
With Garden State Tanning, Inc.
Reid, David F., 60 Hudson Street,
With Lamont, Corliss & Company.
Reiss, Morey K., Municipal Bldg.,
With City of New York, Dept. of Finance.
Riker, John, 230 Park Avenue,
With Frazer and Torbet.
Roche, James Michael, 18 E. 48th Street,
With Harris, Kerr, Forster & Company.
Schwarz, Milton A., 140 Broadway,
With Guaranty Trust Company of
New York.
Sheremeta, Alexander, 346 Fulton Street,
Troy.
Soule, Frank Channing, II, 56 Pine Street,
With Price, Waterhouse & Co.
Stark, Leonard L., 1441 Broadway,
With Freeman & Davis.
Tonjes, George Mortimer, 30 Rockefeller
Plaza,
With First Federal Savings and Loan
Ass'n. of N. Y.
Torgersen, Walter M., 67 Broad Street,
With Haskins & Sells.
Uscott, Herman T., 50 Lafayette Street,
With City of New York, Emergency
Revenue Div.
Walter, Otto L., 505 Eighth Avenue,
With Ralph H. Miller, Inc.
Warantz, Joseph, 1440 Broadway,
With John S. Fogel.
Waxman, Albert, 2 Lafayette Street,
With Hecht & Flaster.
Wheeler, George S., 160 Broadway,
With State of New York Insurance De-
partment—Liquidation Bureau.

Advancement from Associate Membership to Membership

Bernstein, Irving, 1440 Broadway.
Bernstein, Murray, 21 West Street,
With Henry H. Ackerman & Co.
Blanchard, Gordon H., 60 E. 42nd Street,
With Air Reduction Company.
Blum, David I., 521 Fifth Avenue,
With Herwood & Herwood.
Bouton, William DeGraw, 56 Pine Street,
With Price, Waterhouse & Co.
Burton, John Davis, 17 Lexington Avenue,
With The College of the City of New York.
Chernigow, Harry, 516 Fifth Avenue.
Gaisser, John George, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.

Gilbert, Stanley G., 31 Clinton Street,
Newark, N. J.,
With Hoenig & Hoenig.
Glass, William B., 1441 Broadway,
With Nathaniel Kramer.
Haug, Stanley George, 18 E. 48th Street,
With Harris, Kerr, Forster & Company.
Healey, Joseph N., 41 E. 42nd Street.
Heller, Alexander, 302 Broadway.
Hoffman, Joseph, 152 W. 42nd Street.
Isaacs, Melvin, 1440 Broadway,
With Joseph J. Wechsler.
Kaufman, Bernard, 1441 Broadway,
With Hyans, Stern & Co.
Klein, Rudolph Charles, 103 Park Avenue,
With Davies and Davies.
Kravitz, Bernard, 67 W. 44th Street.
Martin, William C., Jr., 80 Broad Street,
With Clarke, Oakes & Greenwood.
Meglaughlin, William Torrie, 165 Broadway,
With Niles & Niles.
Mendelsohn, Harold, 2858 Brighton
6th Street, Brooklyn.
Murison, Allen Eugene, 21 West Street,
With Leslie, Banks & Co.
Neuman, Fred., 95 Madison Avenue,
With David Joseph & Company.
Noonan, Dermott C., Jr., 80 Maiden Lane,
With Touche, Niven & Co.
Peskowitz, Leo H., 21 E. 40th Street,
With B. J. Goldberger & Co.
Scheer, Jerome Harold, 23-27 W. Main
Street, Middletown,
Controller, Roskin Bros., Inc.
Schneider, Ralph J., 1501 Broadway,
With Kamerman & Witkin.
Seelig, Harvey, 15 Union Square,
With Amalgamated Clothing Workers of
America, (Affiliated with C. I. O.)
Shaw, Harry W., 230 Park Avenue,
With National Dairy Products
Corporation.
van Daalen, Jr., Henry A. S., 67 Wall Street,
With Arthur Andersen & Co.
Weyer, William Paul, 1720 Rand Bldg.,
Buffalo,
With Price, Waterhouse & Co.
Zimmerman, Solomon, 406 State Office Bldg.,
Albany,
With New York State Income Tax Bureau.

The number of members in the
Society as of November 1, 1940, is
as follows:

Members	3,304
Associate Members	467
Total	3,771

Fundamentals of Accounting Procedures

(With Illustrations from the Treatment of Taxes in Accounts.)

By GEORGE OLIVER MAY, C.P.A.

I REALIZE that I owe the honor of being asked to address you here largely to the fact that I am the active head of the Institute's Committee on Accounting Procedure and as such have had the great advantage of extended discussion and correspondence on questions of procedure with the members of the Committee, including your very helpful President. Moreover, in extending the invitation to me, your President suggested that my address should have something of a retrospective character. These considerations, and a belief that it is, in general, desirable to combine examination of a specific problem with discussions of a more general nature, have determined the scope of my observations tonight. I propose to discuss some of the developments in the field of accounting principles during the last ten or fifteen years, and to illustrate them by reference to the treatment of taxes in the accounts of business corporations. In recent years there has been much discussion of accounts in their relation to taxation, but relatively little discussion, I think, of taxes in their relation to accounts.

Emphasis on the Income Account

Gilman, in his *Accounting Concepts of Profit*, speaks of the shift of emphasis from the balance sheet to the income account as one of the more important developments in accounting in recent times, and cites the report of the Institute's Committee on Cooperation with Stock Exchanges of 1932 as definitely marking this transition.

It is worth while for a moment to look back a little and trace the history of the change. In the earlier stages of the profession, the preparation of accounts for credit purposes dominated accounting thought. The growth of business corporations, in which stock ownership was widely distributed and was separated from management, created a new demand for accounting services in the interest of those who were concerned with the earning and dividend-paying capacity of businesses rather than with their liquidating value. The profitable years of the 20's greatly increased the number of such corporations and saw, also, a substitution of preferred stocks for commercial paper or other forms of borrowing on a very considerable scale. The increase in the number of stocks of commercial corporations listed on the New York Stock Exchange made it incumbent on that body to take a greater interest than theretofore in the form and content of the annual accounts of companies. The Exchange's decision to do so, and its fortunate selection of an executive assistant to the Committee on Stock List in 1926 were, as I have previously suggested, events which had a marked and beneficial influence on accounting development.

The stand taken by the Exchange on sound accounting treatment of periodic stock dividends was a notable incident of 1929 which had far-reaching effects. The Institute's report of 1932, to which I have referred, was itself a response to the Exchange's effort to find the best way of making its influence effective.

Presented at the Eighteenth Annual Fall Conference of The New York State Society of Certified Public Accountants held at the Waldorf-Astoria Hotel on October 7, 1940.

The shift of emphasis from the balance sheet to the income account was a natural incident of the development which I have briefly outlined.

The depression which followed the collapse of 1929 brought demands for regulation and for the establishment of more precise rules and standards. The profession was warned that unless it could create a degree of uniformity in the practice of its members and in the treatment of accounts of different institutions by its own efforts, it would inevitably find that such uniformity would be imposed on it by external authority. All thinking members of the profession have, I think, agreed that a greater degree of uniformity was desirable and attainable. I think they have also recognized that there was danger to the public interest in attempts to carry uniformity too far. The tendency towards a system of detailed codes and regulations was noticeable in many fields a few years ago. The demand came from two sources—those who wished to regulate, and those who desired the relief from responsibility that is enjoyed by the regimented.

A Change of Trend

More recently, however, a change in trend has, I think, become noticeable. The theory which is claimed to justify the creation of the numerous administrative bodies that have grown up not only here but in all democratic countries, is that in the complex life of today regulation through general laws is unworkable and that the power to deal with problems must be vested in bodies which can ascertain the facts of particular cases for themselves and take action appropriate to those facts. Even the Department of Justice, as you are doubtless aware, is now proceeding on the theory that the specific provisions of an anti-monopoly law are not adequate to

deal with our present business system, and is planning to work out solutions which seem to it appropriate by agreements reached between it and the parties concerned, to which legal effect is to be given in the form of consent decrees.

Stability and Adaptability

I have always felt that in our study of accounting procedure we should be able to profit by the experience in the older profession of the law, particularly of the law in relation to business. I have argued that we face the same problem of reconciling the conflicting objectives of stability and adaptability which have been recognized as existing and presenting difficulty by great jurists, from the earliest days down to Holmes and Cardozo.

I was interested to read recently an article in the *Atlantic Monthly* by a distinguished lawyer in which he pointed out how the emphasis of the Supreme Court was shifting from the first to the second of these objectives. He agreed with the statement made by a special assistant to the Attorney General of the United States in an article entitled *Revolution in the Supreme Court* which had appeared in the preceding issue of the *Atlantic Monthly* that "The revolution consists in part in the willingness of the Court to re-examine established principles and to overrule all precedents which do not seem to it justified, on a purely pragmatic basis, by present needs." The business man can no longer, he said, rely on the authority of decided cases. The doctrine of *stare decisis* seems to be going the way of *laissez-faire*.

It is interesting to observe this tendency in the older business profession at a time when an eager search is being made in the field of accounting for some fixed and fundamental principle to which all accounting procedures can be related and which will stand unchanged in

spite of changing business needs. Such a goal is unattainable—nevertheless the search for it is stimulating and seems likely to produce a clearer understanding and a more coherent body of accounting rules.

Accounting Principles

(a) Consistency

In the past, consistency and conservatism have been generally regarded as the two cardinal virtues of accounting. While no one present will probably have any doubt about the sense in which I use the word "conservative" I should perhaps state it clearly, since the usage, though common, finds little support in the dictionary. The conservative in accounting is akin to the prudent business man of the law. He is cautious rather than sanguine, and would underestimate rather than run the risk of overstating.

At the present time, the emphasis on consistency is perhaps even greater than heretofore, and today its paramount importance is generally recognized. Even when new conditions or improved techniques make changes in accounting desirable, departures from consistency are deemed permissible only if the nature of the change and the broad effects thereof are clearly disclosed.

It is important, however, to note two points—first, that consistency calls for similar treatment of items that are similar in substance and not merely in form; second that consistency does not necessarily require that where a case is dealt with in a given manner, the converse case should be disposed of in the converse way. It is necessary to look to the philosophy underlying the determination in the first case in order to ascertain the appropriate treatment of the converse case. For instance, acceptance of the proposition that an asset should be carried "at cost to the extent that the cost is believed to be recoverable" precludes

taking credit for an indicated but unrealized profit in respect of that asset. It does not, however, preclude, but actually requires making a charge for an indicated though unrealized loss in respect thereof.

(b) Conservatism

The claim of conservatism to be regarded as a cardinal virtue is not today equally unchallenged—some even deny that it is a virtue at all. They point out that conservatism may come into conflict with consistency, accuracy or logic, and that carried to an extreme it may result in positive misrepresentation. It is interesting to examine two recent texts written by authors known primarily for their achievements in the academic field. Sanders, Hatfield and Moore, in *A Statement of Accounting Principles*, make "Conservatism in Accounting" a section heading, and express the view: "The common belief that less mischief is done by understatement than by overstatement is, in the hands of honest men, probably true; but with dishonest men understatement may serve their turn as well as overstatement." They conclude that: "Proper reserves for all purposes should be insisted upon; they are to be regarded as sound accounting and a source of financial strength to the company. To this extent conservatism is to be commended. But to arrive at profits on the books by recognized methods and then to conceal part of them in the published report is a practice which cannot be approved."

In Paton and Littleton's *Accounting Standards* the word "conservative" does not appear as a section heading or even in the index. The authors regard conservatism as something for parentheses or for interpretation of accounts rather than for accounting itself (pages 127-8).

If we accept the test of "justification on a purely pragmatic basis by

current needs" which the Supreme Court is said to be adopting, we shall. I think, conclude that the virtues of a reasonable measure of prudence have been abundantly demonstrated by experience. Nothing, certainly, has shaken my own conviction that the sacrifice of reasonable prudence to a supposed greater theoretical precision would be detrimental to the general interest. In making those estimates which are so generally necessary in accounting we should, therefore, aim to be conservative, bearing in mind always that we should be conservative even in our exercise of conservatism.

The fact that what is conservative for one purpose or in respect of the profits for one year may be unconservative for another purpose or in computing the profits of another year, offers more difficulty, and the importance of this fact grows as the emphasis shifts from accounts as a guide to present financial position and cumulative results, to accounts as a guide to current earning capacity and to the capitalized value thereof.

Inventories

These considerations apply with special force to items like inventory, which may be regarded as a credit to the operations of one year and a charge against those of the succeeding year. As a result, in recent years we have had much discussion of inventory methods such as "cost or market," which have the effect of reducing inventories below cost in some but not all years. Such methods are, of course, to be distinguished from methods under which inventories are carried continuously at less than current cost, as for instance, in the case of the base stock method.

In a talk at the Columbia Institute meeting in May, I gave my reasons for thinking that some sort of "cost or market" basis is called for upon any theory of accounting. I shall

not discuss this specific question in detail today because the whole subject of inventories is receiving the careful attention of the Committee on Accounting Procedure. That Committee has issued a preliminary statement with the hope that it will elicit extensive discussions at the forthcoming meeting of the Institute and through the *JOURNAL OF ACCOUNTANCY*, so that a further statement by the Committee may be framed in the light of a fuller indication of the attitude of the profession on the subject. There is obviously an opportunity and a need to secure a greater degree of uniformity in inventory practices themselves, in the way in which inventory rules are interpreted or applied, and in the way in which the results are presented. The Institute and this Society have here an opportunity to perform an important service which affects accounts of all enterprises, large or small, and is therefore of interest to all members of the profession.

(c) Capital and Income

When we turn from consistency and conservatism and try to discover other principles or primary bases of accounting, we do not find unanimity. A sound distinction between capital and income has at times in the past been regarded as perhaps the most fundamental of accounting concepts. Economic writings and legal discussions of the problems of determination of profits and the propriety of dividends lent support to this view. Sanders, Hatfield and Moore, attempting to describe existing views, regarded the economic distinction between capital and income as vitally important in accounting. Paton and Littleton, undertaking to set forth what *ought* to be regarded as fundamental, minimize its importance; they speak of capital assets as only slow-moving inventory. The analogy is, I think, imperfect, and in any case does not

carry quite the implications they seek to draw. A distinction is commonly recognized between supplies and goods intended for sale or manufacture and it is only to the former class of inventory, if any, that plant and equipment can be considered analogous. My own feeling is that the authors would be more nearly correct if their roles were reversed. As a matter of existing fact, I do not think the economic distinction is a cardinal point of accounting—at least not in our country. I am disposed, however, to think that it ought to be and is likely to be in the future.

The recognition of the major importance of income seems to me to be only a first step—the next is to recognize the importance of distinguishing between different kinds of income. This is true, I think, in economics, taxation and accounting. The income account has come to be recognized as a better guide than the balance sheet to capital value and to ability to pay. Inevitably, it must next be realized that the distinction between different sorts of income is essential to a just appraisal of either.

If in a period of falling interest rates and rising security prices, two insurance companies have the same income but in one case underwriting profits, investment income and capital gains each contribute one-third, while in the other case the proportions are twenty, twenty and sixty per cent respectively, the composition of the figure is as important as the aggregates in any study of the relative values of the stocks of the two companies.

Investment Company Act 1940

This fact was recognized by the New York Stock Exchange at least as early as 1931, and has received signal recognition in the Investment Company Act of 1940. Section 19 of that Act provides that no dividend shall be paid from any source other

than . . . "net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties . . . unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. The Commission may prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors." (italics mine)

We do not, of course, always find transactions and the results thereof falling naturally into clearly differentiated categories. Here, as in accounting in general and in life as a whole, we have to deal not only with blacks and whites, but with infinitely graded shades of gray. Any lines that are to be drawn must be in a large measure arbitrary. But the guiding principles in drawing lines can be satisfactorily established. There is here an important and fruitful field for research and exposition. This research will, I am convinced, among other things lead to the conclusion that the distinction between the assets with which a corporation carries on business, and those in which it trades, is of substantial importance, and that profits realized on the disposition of instruments of production stand on a different footing from profits derived from the sale of products of industry.

(d) Matching Costs Against Revenue

Paton and Littleton accord the paramount place in accounting to the objective of matching costs against revenue. There is a large measure of justice in this view—it certainly comes far nearer the truth than the view expressed by many laymen that accounting is essentially a matter of valuation. But the authors seem to me to exaggerate the extent to which accounting should or can be governed by this objective.

In so far as they undertake to justify carrying forward expenditures after it has become improbable that those expenditures will be recouped, their departure from the traditional view seems to me to be unwarranted and to fail to meet the test of "justification on a purely pragmatic basis by current needs."

(e) The Benefit Theory

Others approach the question from the standpoint that, in general, the object of accounting should be to allocate charges to the income account of the period or periods in which the corresponding benefits are brought into that account. This concept, rather than the distinction between economic capital and economic income, determines the treatment in accounts of what are commonly called "capital assets" and of deferred charges.

Conclusion as to Accounting Principles

At this point of our discussion I am disposed to follow the example of James Bryce in his *Modern Democracy*. You may recall that his chapter discussing definitions of democracy reaches the conclusion that no satisfactory definition can be evolved, but that it is not really necessary to evolve one because everyone knows broadly what democracy means. There are no precise criteria by which the existence of democracy in a state may be determined, and there are none by which the appropriate accounting treatment of a transaction may surely be judged. In both instances a decision must be reached upon the basis of some rather broad concepts and an appraisal of the essential facts in relation to the objectives sought to be attained.

Taxes in Accounts

Taxes have at times been regarded as the price paid by the tax-

payer for the service received from the Government. Upon this view, taxes would be a charge against the year in which the service is received, which might be presumed to be the period in which the taxes are due and payable.

This view was more persuasive when balancing the budget was regarded as a cardinal virtue and when Government activities were restricted to rendering essential services. It has now lost much of its appeal—first, because in theory the creation of surpluses in times of prosperity and of deficits in times of adversity now apparently meets with considerable favor and in practice annual deficits seem to have become normal; and, secondly, because taxes are now used not only to defray the cost of Government services, but to effect redistributions between different groups in the economy.

There is a disposition today, rather, to regard Government as one of the participants in the fruits of enterprise, its participation taking the form of taxes. Governments do not, of course, share in net losses; but in the more recent Federal Income Tax laws there has been a welcome return to the practice of permitting some offsets of losses against gains of different types or of a different period. To this limited extent, Government may be regarded as participating in losses, and the amount of a loss that falls on a taxpayer as being less than the gross loss accordingly.

An alternative approach is to attempt to relate taxes as far as possible to some business fact and to be guided in disposing of them by their relation to that fact. Upon this basis, taxes are in certain cases capitalized. From this standpoint, such charges as social security taxes, and customs and excise duties, offer no difficulty. The period to which property taxes should be charged is not so clearly established, but generally

speaking, perhaps, these taxes are treated in corporation accounts as they are treated for income tax purposes—that is, as a charge against the fiscal period of the taxing authority in respect of which they are levied.

Taxes Based on Income

Difficulties arise particularly in relation to taxes which are based directly or indirectly on income. These take many forms—first, there are taxes such as our Federal Income Tax, which are based on income and are payable whether the business is or is not continued beyond the period in which the income was earned. The New York Franchise Tax is of another type, since although in the majority of cases it is levied on the basis of income of a past period, it is payable only if the business is continued in a later period. A third class may be illustrated by the Colorado Property Tax in so far as it relates to mines, under which the property is assessed at a purely constructive valuation based on the gross or net proceeds of mining of an earlier period. An extremely interesting variant is to be found in the English Income Tax, but this represents an approach to the problem of taxation of income which differs so materially from ours that I shall not discuss it here.

No one will, I think, question the statement that taxes such as the Federal Income Tax should, in general, be treated as a charge to the period in which the income is earned, by which the tax is measured. I shall consider some special cases later.

In the third class of cases, such as that of the Colorado tax on mines, the relation between the earnings and the tax is only indirect, and, further, it may be presumed that all valuations are in some way related to past or prospective earning capacities. This being so, and the tax

being payable by the owner on the property at the date of assessment, which is subsequent to the period of earnings, it can hardly be attributed to that earlier period and should, like other property taxes, be considered a charge against the income for the fiscal year of the taxing authority by which it is levied.

Cases such as the New York Franchise Tax offer more room for differences of opinion. The fact that no tax is payable unless the business is in existence in the tax year would seem in itself sufficient to justify treatment of this tax as a charge against the operations of that year. However, in normal times, when the tax rate is stable and profits perhaps fluctuate, there is much to be said for relating the tax to the profits on which it is based. In such circumstances, the earnings of the profit may be regarded as creating a sufficient presumption that a tax will be payable to warrant provision therefor being made by a charge against the income of that year. True, this may result in creating a reserve which will not be needed if the business is discontinued, but so many assets are carried on the assumption that the business will be continued that this point cannot be given much weight.

If this policy is followed and the tax is materially changed, how should the difference in the resulting tax be treated? The answer would seem to be that the change in rate is presumably attributable to a new situation in the tax year; that the increase or reduction of the tax is not due to the circumstances of the particular taxpayer, and that the amount thereof should be a charge or credit to the income of the year of levy.

Some, of course, will argue that there cannot in any case be two permissible alternatives. If so, which is to be rejected? When a tax is levied explicitly in respect of a given year,

can the right to charge it against that year be denied? It is the taxpayer's contribution to Government for that year, made as a condition of carrying on business during that year. Only in that year does it accrue and become, for instance, deductible under our Federal Income Tax law. But if this is to be the sole treatment recognized as proper, conservatism and, perhaps, the realities are apt to be sacrificed to technical considerations. Myself, I see no reason why both alternatives should not be permitted, provided that the method adopted is clearly described and consistently followed.

U. S. Income Tax—Special Cases

I turn, now, to consideration of some special problems arising out of acceptance of the general principle that in the case of taxes such as our Federal Income Tax, the charge should be made in the year in which the income is earned—not in the fiscal year of the Government in which it becomes due and payable. The proposition might, perhaps, be stated thus: the tax should be charged in the same period as the income on which it is levied is credited to income account. This immediately raises the question of the treatment of cases in which different methods are employed for determining income for corporate reports and for income tax returns.

Differences between Annual Reports and Tax Returns (a) Causes

Differences between taxable income and income as shown in the annual report may arise from the following, among other causes: (1) that the law either permits deductions which are not called for by sound accounting or does not permit all the deductions so called for; (2) that the corporation in its allocation of profits as between years follows procedures which are either more or less liberal than income tax practice

permits; (3) that profits or losses are includible in the income tax return which are excluded from the income account and credited or charged to surplus (if they are charged against reserves for contingencies created out of the income of prior years they fall in the preceding category); (4) that the law permits carrying forward losses of earlier years as a deduction in a later year.

The first class, in which tax law is either more or less liberal in its long-run effects than accounting requirements, may be illustrated by allowances for discovery depletion and the restrictions on deductions for depletion and capital losses which have at times existed; it presents no accounting problem.

Many illustrations can be found of the second class. An important case is that of vendors on the deferred payment system, who take advantage of the privilege of making returns on the instalment basis but keep their accounts on the basis of actual sales with, of course, proper reservations for cancellations and subsequent costs. Another case is that of financial companies which take up profits or losses on sales of securities in their tax returns on the basis of identified units, but in their own accounts on the basis of average cost. The case of public utilities which take deductions for depreciation in their tax returns in an amount exceeding the sum reported in their annual accounts as a charge in respect of property exhaustion or retirement should perhaps be regarded as falling in this category. A fourth case is that of companies which provide for depreciation on a more liberal basis than is permitted for tax purposes, with the result that when property is abandoned they have losses which are deductible for tax purposes but have already been provided for on the books. This class of cases presents some difficult accounting problems.

(b) Accounting Problems Created

In the case of instalment sales there is a clear deferment of profit for tax purposes, and logic and conservatism would both seem to call for a reserve for tax on the profit taken credit for in the accounts but not yet returned for taxation. Just how the reserves should be calculated is a problem which is made more difficult by the fact that the regulations do not conform to any consistent accounting theory. I think, however, that in principle the propriety of establishing the reserve is generally recognized.

In the case of financial companies using different methods for computing profits on sales, and in that of public utilities using different treatments of property exhaustion, there is not the same clear deferment of profit for tax purposes. The effect of the procedure adopted is no doubt to tend to produce greater taxes in the future than if the returns had been made on the same basis as the company's own accounts. But whether such taxes will actually be payable, and if so, when and in what amounts, are subjects of conjecture, not of estimate. These situations cannot well be dealt with by reserves—the only requirement would seem to be fair disclosure.

The case in which corporations make more liberal provisions in their own books than are permitted for tax purposes may be regarded as the antithesis of the first case, since there is a reasonable expectation that these procedures will have the result that in a later year taxes will be paid on an amount lower than the income then shown on the books. No one would, however, I think, suggest that a part of the tax paid in the earlier year should be regarded as a deferred charge to be written off in the year or years in which the corresponding benefit is realized. Conservatism precludes such a procedure, however logical it may seem.

Capital Gains and Losses and Other Income

The proper treatment of income tax in cases in which charges or credits are excluded from the income account but enter into the determination of taxable income, is sharply raised by Section 19 of the Investment Company Act of 1940, to which I have already referred. Does the exclusion of capital gains and losses in the determination of income which may be distributed without any statement as to its source, imply the exclusion of taxes directly attributable to capital gains, and if so, how is the case of a capital loss to be dealt with?

Suppose an investment company to have an income from dividends and interest of \$100,000 in each of two consecutive years, and to make capital gains of \$50,000 in the first, and capital losses of \$50,000 in the second. Assuming the tax rate to be twenty per cent, it would pay \$30,000 income tax in the first year and \$10,000 in the second. Is the amount of income available for distribution without disclosure of the source \$70,000 in the first year and \$90,000 in the second, or is it \$80,000 in each year? Corporations which have attempted to segregate capital gains in the past have encountered this problem and I do not think any uniform or entirely satisfactory solution has up to now been evolved.

Charges and Credits to Surplus

Similarly, a question may be raised whether, when extraordinary profits or losses are carried to surplus account, there should be a charge against income account computed as if no such charges or credits existed and the difference between the tax so computed and the tax actually payable should be charged or credited to surplus account. Where the extraordinary item is a loss, many corporate executives

and accountants alike will no doubt find it difficult to accept the idea that the income account should be charged with a tax which does not actually have to be met. On the other hand, there is an obvious objection to permitting the charge of an extraordinary loss to surplus to have the result not only of relieving the income of the year of that charge but also of reducing the income tax charge and thus producing a larger final figure of income than if the loss had not been incurred.

Consideration of such cases may be said to strengthen the argument that extraordinary items should not be excluded entirely from the income account but should be shown separately therein. It is, however, only fair to point out that most of those who advocate this course propose that the account should be divided into two parts and that if this is done the problem of deciding in which part to show the income tax and the extraordinary loss will remain. It is perhaps hardly possible to lay down any general rule to cover this class of cases, but where the amounts are significant there should at least be a clear disclosure of the essential facts and of the effect on the income account of the procedure adopted.

The case in which the income tax for a year is reduced as a result of bringing forward losses from a previous year is one which calls at most for disclosure.

Conclusion

There are many other phases of the problem of allocating taxes in accounting with which I should like to deal if time permitted. One in particular which I should like to discuss is the treatment of taxes which may become payable when dividends are received by a parent company from subsidiaries out of their undistributed profits which

form a part of consolidated earned surplus. But this would carry me into a consideration of much broader issues relating to the significance of dividends—a subject which must be reserved for another occasion.

What I have said, though necessarily incomplete, will, I think, suffice to show that there are conflicting broad principles relating to tax allocations for each of which a respectable case may be made; that in some cases alternative treatments would seem to be equally permissible, and that the disposition of the tax in many cases cannot be determined by a rigid formula but can only be reached by consideration of all the circumstances in the light of broad concepts of what constitutes good accounting. These conclusions are not exceptional—they emerge whenever an important group of accounting questions is considered; they are indeed made inevitable by the nature of accounting.

I referred earlier to the development which has brought into existence regulatory bodies with large discretionary powers to which general indications of policy have been given by the Congress and whose decisions are made subject to appeal to the courts only in cases in which the discretionary powers may be claimed to have been grossly abused. I think the considerations which have led to the creation of these bodies call equally for delegation to the accounting profession of discretionary powers to be exercised in accordance with broadly outlined principles of accounting and subject to disciplinary action by either its own professional bodies or the appropriate regulatory authority in any case in which discretion is shown to have been abused or not exercised in good faith. We cannot, of course, expect to secure acceptance of this view unless we show a willingness and an ability to lay down through our professional bodies broad stan-

Fundamentals of Accounting Procedures

dards of accounting, and can demonstrate individually that we have the knowledge, the judgment, the character and the courage that are necessary to recognize them and apply them intelligently, honestly and fear-

lessly. The alternative is that accounting will become a system of meticulous rules, mechanically applied, and the calling one which will cease to have any appeal to men of vigorous and independent thought.

The Internal Organization of an Accounting Practice

By BENJAMIN GREENBERG, C.P.A.

CERTIFIED public accountants are specialists in organization and system work, yet how many accounting firms have perfected their own internal organization and system to the same degree as that of their clients? From the commencement of practice, the sense of professional responsibility naturally prompts primary consideration of the problems of clients with secondary consideration only of internal problems in the accountants' own office. But we cannot overlook the importance of that internal organization. Furthermore during the past decade, the increase of responsibilities and work imposed upon accountants has not been paralleled with a corresponding increase in the income of accountants. It is, therefore, timely for each practitioner to pause for a moment and consider in what direction his practice is headed.

Our Committee, sensing the need of awakening practitioners to a realization of the importance of internal organization, has undertaken studies of different phases of the subject. The results of these studies will be made available, from time to time, to the members of the Society. Our first step was the mailing of a questionnaire to all accounting firms represented in the Society. It is indicative of the intense interest of the members in the work of the Society that out of 800 questionnaires mailed, a 25 per cent response has been received. That is better than the average response to informational questionnaires of a voluntary nature. The replies furnish a cross-section of con-

ditions existing within the profession.

I shall endeavor to present to you briefly the results of the questionnaire study and an outline of the matters which accounting firms should consider in planning their internal organization. My colleagues will develop specific phases of internal procedure in greater detail.

Fiscal years:

Do accountants practice what they preach? One illustration should suffice. Accountants have been shouting natural fiscal year from the house tops and have been exerting pressure on their clients to change to natural fiscal years. But, what do accountants do in their own affairs? The questionnaire study indicates that 65 per cent of accounting firms close their books on December 31, the most unnatural closing date accountants could select.

April 30, June 30 and October 31 are more logical fiscal year closing dates for accounting firms. These dates took second, third, and fourth place in the questionnaire study.

At this point, it is in order to mention that we are here dealing with a subject about which there should be no important differences of opinion. What may be considered essential for the large firms may not be required in smaller offices, but in each case, the fundamental principles and objectives should be the same. There is no "right way" of doing things. What may appear to be the right way for one firm may prove to be the wrong way for

Presented at the Eighteenth Annual Fall Conference of The New York State Society of Certified Public Accountants held at the Waldorf-Astoria Hotel on October 7, 1940.

another firm. Thus, in the case of fiscal years, for example, the nature of one practice might justify an April 30 closing, whereas in another case, an October 31 closing would be preferable. That applies to the entire gamut of internal problems. We do not want anyone to take away from this meeting the feeling that this Committee is endeavoring to prescribe uniform practices and procedures for all accounting firms. If in your opinion what you are doing is proper for your office, that should be the deciding factor. All we hope to accomplish is to start you thinking about these matters.

Size of accounting firms:

The replies to the questionnaire were tabulated according to the size of the accounting staffs in order to disclose the relative composition of the firms we were able to classify:

Firms	Staff	Per cent to number of firms reporting
84	One to five	42
74	Six to ten	37
23	Eleven to twenty	11½
13	Twenty-one to fifty	6½
6	Over fifty	3
200		100

Branch offices:

Most accounting firms reporting have only one office. About 20 per cent of the firms reported one or more branches, many of which are located outside of New York State and some outside the United States.

Partners:

About 50 per cent of the reporting firms have two partners. About 15 per cent have three partners. In the remaining cases, the range is from one to eight partners. One hundred eighty-one firms answered this question and reported an aggregate of four hundred fifty-eight partners located in New York State, or an average of about three for each firm.

Certified public accountants:

About eighty-four hundred CPA certificates have been issued in this state. Many holders of CPA certificates have passed away; others have changed their line of endeavor; others are located out of the state.

Considering the reporting firms as representative of 25 per cent of the profession, the questionnaire study indicates that about 4,000 certified public accountants are engaged in the practice of public accounting in New York State. The study also indicates that half of the certified public accountants engaged in the practice of accountancy are partners and half are employees. Parenthetically, it may be of interest that the present membership of this Society is about 3,300, not including the associate members.

Maximum and minimum accounting staffs:

The perennial problem of maximum and minimum staffs will find no solution in these discussions but we hope that each of you will receive some helpful suggestions.

Eighty-four firms, 42 per cent of those reporting, had no such problem. They maintained uniform staffs throughout the year. Eliminating these eighty-four firms from consideration, the remaining one hundred and fourteen firms report aggregate minimum accounting staffs of 1,421 and maximum staffs of 2,037, a differential of about 600, or over 40 per cent based on the minimum. For all of the one hundred and ninety-eight firms reporting, the minimum was 2,018 and the maximum 2,634. These figures refer to accounting staffs. Partners and general personnel have not been included.

Types of engagements and fee arrangements:

Periodic engagements predominate with 142 firms and annual engagements with 58 firms. Several of the

reporting firms are specialists in specific types of work. Predetermined fees predominate, although 53 firms report that the majority of their engagements are on a per diem basis.

Departments in accounting office:

There is too little appreciation on the part of clients of the ramifications of an accounting office and the amount of time and attention given to clients' affairs within the office. It might be well for accountants to invite clients to visit their offices at least once a year. The clients would then have a better appreciation of the broad service which an accountant renders.

Besides the accounting staff, the following departments must be provided for in the organization of an accountant's office:

- (a) Filing
- (b) Typing and stenographic
- (c) Comparison
- (d) Review
- (e) Tax
- (f) Costs, system and budgets

Bookkeepers, secretaries, comptometer operators, telephone operators, a librarian, mailing clerks and office boys will also be found in many offices. The number of individuals which comprise the organization is not what governs. Each office, from the one-man firm to the very large firm, has one or more persons who handle each of the different functions just mentioned.

Physical location and layout of office:

The selection of the physical location and layout of an accountant's office is of paramount importance. Plenty of light and fresh air, adequate space, suitable furniture and equipment, are matters meriting consideration in selecting a new location and planning the layout. The environment and working conditions of your

employees should be made as pleasant and as comfortable as possible.

Accountant's library:

The average accountant is a well-rounded and educated individual. Besides his technical training in accounting, he must be familiar with and keep abreast of business laws, tax laws, government finance, economic conditions, world affairs, foreign exchange, corporate finance, credit practices, and many other subjects. He must have a good command of English and be able to express his thoughts clearly, concisely and in fluent style.

In a typical library of an accountant, one would find:

- (a) Books on accounting, finance and economics
- (b) The bulletins and other literature of the New York State Society of Certified Public Accountants
- (c) The Journal of Accountancy and other literature of the American Institute of Accountants
- (d) The literature of the National Association of Cost Accountants
- (e) The Accounting Review
- (f) The periodicals of the New York and National Credit Men's Association and the Robert Morris Associates
- (g) The publications of the Controllers Institute of America
- (h) The releases of the Securities and Exchange Commission
- (i) Internal Revenue bulletins and U. S. Board of Tax Appeals decisions
- (j) Services covering the various federal, state and municipal tax laws
- (k) Services covering business legislation, as the Wage and Hour Law and the Robinson-Patman Act.

Accounting department:

The selection and training of personnel for the accounting department will be discussed by another speaker on this program. Its importance cannot be overemphasized. A smooth functioning accounting department must make provision for:

- (a) The advance planning of assignments for staff members
- (b) The advance planning and budgeting of the scope of each engagement
- (c) The control of engagements before commencement and while in progress
- (d) Methods of spreading the peak and utilization of idle time.

Filing and typing departments:

In the organization of the filing and typing departments, numerous time and labor saving devices can be obtained. Although costly at the outset, adequate equipment will produce savings for the accountant in a short space of time. The proper selection and training of personnel for these departments should, of course, not be overlooked.

The average client is a busy and impatient individual. He looks to his accountant to translate business transactions in a concise, simple and understandable manner. The accountant's report is the permanent evidence of a completed engagement. A good impression by competent partners and accountants may be completely overshadowed by a poorly prepared or poorly typed report containing grammatical and typographical errors. Consequently, too much care cannot be exercised in the development of an efficient typing department.

Stationery and supplies:

Stationery and supplies, including forms for internal and external use, are important tools in the conduct of

an accounting practice. Our Committee proposes, during the forthcoming year, to obtain from the membership, copies of the different forms used in their offices and prepare scrap books available in the offices of the Society for reference purposes. We hope that the members will cooperate and supply these forms when we ask for them. It should suffice for the present to remind you that stationery and supplies constitute a substantial item of overhead. Intelligent purchasing with due regard to quantities and quality will generally reflect itself in the efficiency of the organization and the regard for its work by outsiders.

Staff manuals:

In order for an accounting office to operate efficiently, there must be rules and regulations. These are not intended to do away with individual thinking. They are intended to provide a harmonious, smooth-functioning organization, free from misunderstandings and prolonged differences of opinion. Among the matters which require formulation of policy are working hours, compensation arrangements, overtime practices, vacation arrangements, travel allowances, and many other details which once agreed upon, will save hours of valuable time and annoyance of reiterating policies and procedures. Many accounting firms have reduced their rules and regulations to writing in the form of staff manuals.

In passing, it is of utmost importance that every practitioner formulate definite rules in regard to:

- (a) The confidential nature of accounting work
- (b) The relationship between the staff accountant and the client
- (c) The relationship between the members of the staff

- (d) The performance of outside professional work
- (e) Personal conduct of members of the organization.

Our Committee, during the course of the coming year, will give thought to the development of suggestions to the members of the Society on these and allied subjects.

Time, cost and billing controls:

Controls must be instituted and records devised for time, cost and billing purposes. The payroll is the largest single item of overhead in every accounting office. An accountant who fails to concern himself with time and cost of engagements, may be prosperous for a time but will eventually pay the penalty for failure to observe in his own office the simple rules of procedure which he recommends to his clients.

Among the prevalent practices indicated by the questionnaire replies are:

- (a) Weekly time reports by each staff member and partner, accounting for time chargeable to clients and nonproductive time
- (b) Fraction of one-quarter hour as the minimum unit of time
- (c) Cumulative record of time devoted to each client's affairs
- (d) Per diem rates, for cost and billing purposes, by classification of accountants (rather than separate rates for each partner and staff member).
- (e) Billing for overtime at regular work-day rates.

Among the less prevalent practices indicated by the questionnaire replies are:

- (a) Time reports by typists and comparers for time chargeable to clients
- (b) Cumulative record of productive and non-productive time of each staff member
- (c) Computation of the dollar cost of time devoted to each engagement
- (d) Computation of profit and loss on each engagement
- (e) Allocation of overhead to each engagement
- (f) Signed agreements or confirmations stating the scope of the engagement and the fee or rates to be charged.

The replies indicate no uniformity in the treatment of office time devoted to clients' affairs, particularly the time of reviewers, partners, typists and comparers. There are also wide differences in regard to the definition of and methods of computing cost of each engagement.

Conclusion:

Finally, having developed a highly efficient organization the partners must take into account the human element and make provision for reasonable risks by adequate insurance coverage.

There is a common saying in the legal profession, that a lawyer who acts as his own counsel has a fool for a client. That saying might apply to accountants. It might be wise for an accountant occasionally to engage another practitioner to review his internal organization and system and obtain recommendations as to accounting methods and procedures. In any case the time and thought given by an accountant to his own organization should be well rewarded.

Staff Selection and Training

By RAYMOND G. ANKERS, C.P.A.

IT is difficult to discuss the selection and training of personnel without saying a few words with reference to staff organization. If staff organization is not planned, then training of personnel benefits only the employee and selection is resolved by hiring the best man available to meet present requirements.

The quality of the work of any firm depends to a great extent upon the ability of its staff. Similarly, satisfactory relations with clients are the direct results of the character of the personnel. Therefore it is of vital importance to an accounting firm that staff organization is planned and diligence exercised in the selection of staff members.

Furthermore, an accounting staff will function at its best where the internal relationships are most harmonious, and this condition will exist only if staff members are promoted to meet needs for expansion or replacement. If this policy of vertical expansion is followed, the junior of today will be the senior of tomorrow and the employment problem becomes one of selecting juniors who have the capacity to develop. Of course, it may become necessary because of rapid expansion to employ supervisors and seniors who have gained experience elsewhere. In this event such men would be absorbed without retarding the progress of the present staff and it is unlikely that anyone will become disturbed if horizontal expansion becomes necessary, when it is known that the policy of vertical expansion also continues to be followed.

The problem of selecting juniors brings to mind the quotation from

the Bible, "Many are called but few are chosen." Indeed, it is not difficult to find applicants for the position of junior accountant but it is never easy to locate nor recognize in the prospective junior today one who will have those qualifications essential to a senior or supervisor ten to fifteen years hence. Firms following the policy of vertical expansion are always on the lookout for that type of junior.

There is little likelihood that any employing practitioner is unfamiliar with the channels through which applicants may be secured. But Mr. Gantt, in his quiet way of coordinating the activities of the various committees of the Society, indicated that it would not be amiss to mention that the Committee on Employment of the New York State Society has approximately 300 current personnel files of applicants who have registered for positions. These applicants range in ability from juniors to supervisors, and from bookkeepers to controllers and treasurers.

The employment agencies are another source from which applicants may be obtained. However, if you expect to enlarge your staff and are interested in promising young juniors, the agencies are not likely to be the most fertile field. It is unlikely that the most desirable college graduates make a bee line to register with the agencies immediately after graduation.

It is hardly necessary to mention that unsolicited letters of application, recommendations of friends and of clients are also prolific sources, often leading to time-consuming interviews.

Considerable time can be saved

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and good results obtained in selecting junior accountants by communicating with the vocational departments of colleges and universities. These institutions are interested in finding employment for the men in their graduating class and will gladly send reports on several men they consider outstanding. At your request, each report will include a copy of the man's scholastic record, a statement of his extra curricular activities and his picture. You may then interview only those whom you deem worthy of further consideration.

To take full advantage of this method, it is desirable to plan several months in advance the number of men you will require so that interviews may be arranged soon after graduation.

In the final analysis the selection of assistants can be made only after an interview. The interview should not be a hurried affair; it requires patience and searching questions. Consideration must be given to appearance, personality, scholastic record, past experience, disposition, reason for interest in the profession, how long the applicant has been interested in accounting work, whether he is disposed to hard work or believes success is a matter of luck; whether he has imagination and whether he expresses himself clearly and to the point. A simple written examination may also be given to ascertain if he possesses a knowledge of fundamental accounting principles and is able to express himself in writing, legibly and grammatically.

Engaging temporary help is often fallaciously considered as being something separate and distinct from hiring men on a permanent basis. Obviously there should be no less care exercised in engaging men for temporary work than for permanent employment. When employing temporary help, the principal seeks to obtain the same type of men he

would employ for his permanent staff, except that usually he is not primarily interested in whether the temporary employee has capabilities of development.

In addition to the interview, it is extremely important that character references and references from former employers be obtained. References should be in writing. The number of references depends to a large extent upon the number of positions held by the applicant and the period each position was held. As a general rule, four references, selected to cover an applicant's employment for the five preceding years would seem sufficient. However, if the applicant had but one or two positions during the five years, it would be well to receive a reference letter from other former employers. The value of character references is problematical but it is customary to request one or two.

The method of training personnel is largely dependent upon the size of the staff and the type of practice conducted by the accounting firm. But regardless of what method may be followed in training personnel, it is of vital importance that the junior accountant receive guidance when entering the profession. One of his first duties should be to read the "Rules of Professional Conduct" prescribed by the American Institute of Accountants and those forming Article XVIII of the by-laws of our Society. He would also profit by reading "The Duties of a Junior Accountant" by Alfred Cipriani, and "My Career in Business," by Walter Hoving. The latter is a recent book and though not on the subject of accounting, it may be helpful in establishing in the junior's mind his relationship to his employer and his place in the business world.

He should receive instructions on how to conduct himself in clients' offices and what his attitude toward and relationships with clients and

Staff Selection and Training

clients' employees should be. Dress may not make the man, but most clients are not impressed by the young accountant whose appearance is either slovenly or flashy. Explain that to the beginner. Also emphasize the seriousness and importance of his new work.

Several of the larger firms follow the practice of employing men shortly after graduation from colleges and universities. These men are frequently asked to report for work during the latter part of the summer or early fall, but are not assigned to staff work for the first two or three months. During this period they receive instruction under the direction of a supervisor or partner.

This instruction fills the gap between the technical college training and practical staff work. Lectures are given by various staff members and working papers and reports are used to demonstrate the matters discussed. The work often includes the use of practical auditing sets, solving problems which have appeared on C.P.A. examination papers and learning how to add rapidly and accurately. It is astounding to find that inexperienced men may know the answers to intricate accounting problems but are not reasonably rapid in simple mathematics.

Other firms follow the practice of having inexperienced juniors spend at least one year in their report and comparing departments before being transferred to the accounting staff. This practice enables the embryo junior to become familiar with the procedures and practices of his employer, to observe working papers, statements and reports and to gain experience in dealing with figures.

However, the foregoing are merely stepping stones to the real training which the junior should obtain when he is assigned to accounting engagements. Here, he will find that his superiors will go out of their way to give him the benefit of their experi-

ence and will apportion to him more responsible work as soon as he is able to handle it. Assistants should be assigned to work under the direction of different seniors and on different engagements for at least the first few years. In this way, he learns that there is more than one approach to the same type of problem and that records and procedures vary widely with different types of businesses.

But it should not be inferred that training ceases when a junior becomes a semi-senior. In a sense, training never ends, although the method of training experienced accountants is more comparable to adult self-education. All staff members should be encouraged to obtain the certificate of certified public accountant, to keep abreast of current accounting literature and to join and take an active part in the work of accounting societies. Staff conferences held at frequent intervals are helpful to keep the staff informed of changes in tax laws; of recent rulings made by the Securities and Exchange Commission and of other accounting matters of general interest. Where staff conferences are not feasible, bulletins regarding such matters will attain the same results.

The individual progress, not only of junior assistants but of all staff members, should be followed by the principal. The larger firms must necessarily obtain this information in the form of written personnel reports. These reports are prepared by supervisors or seniors and cover the work and progress of their assistants. Personnel reports should express the opinion of the accountant in charge as to how he would grade each assistant, that is, as a senior, light senior, semi-senior or as a junior accountant. The report should also include information as to the assistant's accounting ability, personality, handling of clients, etc., and make mention of any outstand-

ing faults. These reports are not worth the paper upon which they are written unless they are used as a basis for advancing assistants and for discussions with them of reported faults and how they may be corrected. Because of their confidential nature, personnel reports should be reviewed only by the employer and the personnel director.

Personnel reports are not needed if the size of the firm permits the principal to have direct supervision over his assistants. However, even here it would be desirable for the principal to reduce to writing his opinion of each staff member once a year. Such memoranda will not only indicate to the principal the progress each staff member has made over a period of years but it will be of value to him when writing reference letters regarding former employees.

When it is noted that an assistant has made little or no progress over a period of two or three years, a conference should be arranged to determine the reason. In some instances the assistant will admit his waning interest in his work and his desire to enter another field of endeavor. In other cases, the assistant may still be keenly interested in professional accounting, but apparently lacks some aptitude essential to suc-

cess in his present work. Lack of progress might also result from a clash of personalities for which the assistant may or may not be entirely responsible. A change in assignments may be the solution to such a problem. In any event, drastic action should not be taken until it is quite evident that the man will not develop. When this is discerned, it would be doing the man an injustice to retain him. Every effort should be made to place him in the field of endeavor for which he is best fitted.

In conclusion, I would like to quote from an article appearing in the August, 1940, issue of Harper's Magazine. This article, written by Roy Helton, is entitled "Born in 1921" and considers the problem of choosing a career. I quote:

"To young men and women able to choose a professional career and naturally interested in the possible reward, it can be frankly said that among law, medicine, and engineering, on a financial basis, there is no marked difference in probable earnings. The average net incomes of physicians and lawyers and of certified public accountants are all in the same range—around four thousand dollars a year—certified accountants having somewhat the edge on the other two professions."

Typing and Filing Procedures

By MISS GERTRUDE PRIESTER, C.P.A.

AN accountant may be criticized as much on the appearance of his report as on the actual work done, and he must therefore consider the completed report as his best tangible record to the client of the manner in which his work has been conducted. Carelessly typed reports, poorly set up and difficult to read with typographical errors are a reflection on the accountant. For these reasons it is important for the accountant to know the equipment needed by the typing department and to set standard rules and methods to be observed by the senior accountant in the form of his report, and by the typing department in setting up the statements.

As to the equipment required in the typing department, this may be summarized as large and small carriage typewriters, Error-No or Line-A-Time machines, paper, carbon, ribbons, typewriter shields, ample desk space for assembling reports, and ample space in cabinets and files for the keeping of report paper and income tax return forms.

All typewriters should have the same type and all ribbons should be matched so that if more than one typist is working on a report the typing will be identical. The latest model typewriters now make it possible for twenty legible copies to be typed at once. These machines should be kept in good working order at all times. Some firms use a combination bookkeeping machine with adjustable registers and cross-footers for the typing of reports and this, of course, eliminates the necessity for re-checking footings.

Care should be exercised in the

purchase of report paper and carbon. The report paper should be of good quality to permit the making of erasures without ruining the nap of the paper. Cheap paper will sometimes wrinkle in damp weather. Many firms have paper made with their own watermark for the purpose of preventing substitution of any pages in their report. Carbon paper, too, is an important factor in making clear, legible copies. Atmospheric conditions affect cheap carbon paper and erasures result in smears and smudges that certainly do not enhance the appearance of a report.

The Error-No or Line-A-Time machines and the metal typewriter shields are really essential because they save time. The Line-A-Time and Error-No machines are placed in back of the typewriter and have a line-by-line guide. The typist may look up at the statement without straining her eyes or sitting in an uncomfortable position in order to copy the written report. The metal typewriter shields avoid the necessity of placing small slips of paper in back of each sheet of carbon when making a correction. The shield is simply placed in back of the sheet being corrected, and since it is formed to fit the typewriter, corrections may even be made on the last line of the page.

Cabinets and files should provide for ample room for storing the necessary paper and supplies, and the amount of space will be determined, of course, by the requirements of each office. It is important, however, to have cabinets for keeping tax return forms so that it will not be necessary to fold them. These

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cabinets should be properly indexed so that no time will be wasted by the typist in hunting through the files for the proper returns.

Standard Rules

Practically all firms set their own rules for the manner in which statements are to be set up. Some firms have regular pamphlets printed for the use of new employees, setting forth what items should be capitalized and underlined, the headings and margins, the number of spaces between headings, indentations, etc. The senior accountant should also have a copy of these rules in writing his report and setting up the statements, so that it will not be necessary for the typist to make too many changes in order to conform to the rules of the typing department. The report and statements should be complete when sent to the typing department. A uniform system of setting up statements permits more than one typist to work on the report and statements. This insures uniformity of appearance.

After the report has been typed, it is customary to have one carbon copy of the typed report compared with the written copy of the report. The office copy of the typed report is used for this purpose. In order to make sure that the necessary precautions have been observed in comparing the typed report, a rubber stamp is usually placed on the reverse side of the typed copy containing the following information: "Compared from to....." "Footings Checked," "Corrections Examined," "References Checked." The two persons comparing the report should look for grammatical and typographical errors. Some firms require that they also consider carefully every statement made in the report in case something may have been overlooked by the reviewer. The two persons comparing the report must sign for

the comparison by initialing the "Compared from..... to....." If there are no typographical errors, the "Corrections Examined" is simply filled in by a check mark. If there are typographical errors, all copies of the statement must be corrected and presented for examination before the "Corrections Examined" may be initialed. The person checking footings indicates footing check marks on the typed copy and signs his initials on the reverse side. To do this work, it is customary to have either a comptometer operator or a Burroughs Calculator operator check footings to save time. However, some firms still insist that juniors should add without the use of modern devices. When statements have been compared, examined for corrections and footings checked, the report and statements are assembled and read by one person. This is usually done by the senior accountant who prepared the report. While reading the report, all references must be checked. Every precaution must be taken to guard against errors in the report. The finished report should be uniform and neat in appearance. I know of some firms that will not permit any lines to be made on the typewriter, but prefer to hand-rule all the reports with red and blue ink. While this does require a considerable amount of time, it enhances the appearance of the report.

No mention is made of the manner in which the work is to go through the report department as this paper is confined to the prevalent procedures rather than the method of arranging time. However, it might be stated that idle time in the typing department is frequently used to type up statements with the names of accounts, and if comparative figures are to be used, to insert the prior year's figures. These statements are given to the senior accountant to avoid the necessity of

his writing in long-hand the names of the accounts.

Filing procedures and the maintenance of records vary in practically every accounting office. It is essential, however, that standard rules again be applied for the classification of working papers, the maintenance of report files, instructions re general correspondence, and the keeping of adequate records for follow up of due dates of tax returns for clients.

Files are usually arranged either alphabetically or numerically. In the alphabetical system, all reports pertaining to one client will be filed in a group. In the numerical system, a separate number is given each file envelope and an alphabetical guide is kept in a loose-leaf book. Tax returns are also numbered. The numbers of the report and working papers would be identical, although the report files and working paper files are kept separately. Cards should always be inserted when taking either working papers or reports from the files. The file clerk should know at all times where all reports are or the person responsible for taking the papers out of the file.

Some firms also have what is known as "permanent working paper files," alphabetically arranged. These permanent working paper files are kept separately and contain data and information which may be needed from year to year—such as copies of the certificate of incorporation, bond indentures, special agreements, transcripts of minutes, etc. Copies of minutes taken from a client's records are usually made in duplicate—one copy pertaining to the current year filed with the working papers for the year, and the other copy filed in the "permanent working paper files."

The general correspondence file should have a copy of every letter written to or received from a client. Letters written regarding the fee

and scope of the work to be done should be available to the senior accountant and to the bookkeeping department by making extra copies and sending them to the proper departments. It is interesting to note that only about 25 per cent of the replies received to the recent questionnaire sent out by this Committee, indicated that it was a practice of the firm to confirm by letter the fee arrangements and the scope of the work to be done.

It is of the utmost importance that an accountant being sent out to make an audit, should know the scope of the work to be done. If proper records were kept of the arrangements made, it would save considerable time both for the accountant and for the client.

Any letters relating to pending tax cases should have copies filed in the tax file to which the correspondence is applicable.

Every accountant should keep a control record of the tax returns to be filed for his clients.

Numerous ways and means have been devised for follow-ups and check-ups to avoid any oversight in the preparation of returns on or before the due date. Some smaller firms use an alphabetical list of their clients and have columns for every month of the year. The month column is subdivided into three columns with headings reading "due date," "form number," "completed and sent to client." These lists are made up for each year. The larger firms frequently use a Rand Kardex System—making up a card for each client and indicating thereon the returns required to be filed by the accountant. As a new tax law is enacted, a responsible person rechecks the entire list and if necessary, consults with the senior accountant and the client regarding their liability under the new tax. Under this procedure, about thirty days before a return is due, a com-

plete list of the clients whose returns are due for filing on a certain date, will be made up and as each return is completed and sent to the client, it is so indicated on this list.

With the severe penalties and assessments that may be made by the various taxing units, it is of vital importance that every accountant keep an accurate control of the tax returns to be filed for his clients.

The length of time that reports and files are maintained at an accountant's office varies with the amount of space available. Much has been written about the number

of years working papers and reports should be kept and whether it is advisable to destroy them after a certain date. Personally, I do not believe any working papers or reports should be destroyed. Opinions differ, and there is still no hard and fast rule. Most firms, when their own files become too crowded, hire space in a storage warehouse, near enough to the office to permit the taking out of papers within a few hours' time. Most firms maintain in their own offices only about three to five years' reports.

Time, Cost and Billing Records and Controls

By STEPHEN CHAN, C.P.A.

BEFORE discussing this paper, it should be understood that I do not recommend that all accounting offices standardize their procedures in order to adopt the methods to be outlined. However, with the thought in mind that the efficient control of an accounting practice requires records no less accurate and informative than those used in other pursuits, I believe that the average firm may find herein several items of interest and may thereby improve its records or record-keeping.

The system around which this discussion is built was designed as applicable to firms ranging in size to fifty men, but the basic principles can be amplified to serve the needs of larger organizations.

Unit of Time:

One of the most important factors in billing clients is the time spent on the engagement. The unit of time most frequently used in billing is a day comprising seven hours.

The Time Sheet:

The primary time record is the report filled out by each staff man and partner, as well as by typists and comparers where practical.

The replies to the recent questionnaire indicate that the great majority of firms use time sheets for staff men. A smaller majority indicate that time reports are also prepared by partners, and approximately one-third of the firms replying report the use of time reports by typists and comparers. Weekly reports are favored.

The time sheet may take one of several forms but should provide for

the employee's name, the date the reporting period ended, the clients chargeable, a concise explanation of the work done, the hours spent each day, (including unassigned time) and the total hours applicable to each client. The back of the time sheet form may also provide for expenses, data regarding traveling time or other information.

It is obvious that the staff should be impressed with the importance of accurately recording the time spent on each engagement.

Since the title of the person responsible for the maintenance of the time and cost records will differ in nearly every office, no attempt is made to define his duties, but this dissertation is confined to the content and purpose of these records.

Basic Time Record:

The first sheet of the time control record book (usually a loose leaf binder) may contain, on the left-hand side, running down the page, a listing of the staff by name, in alphabetical order. Opposite each name and running across the sheet will be spaces in which to record the total hours indicated by the time sheet as chargeable to clients and the total representing unassigned time.

This summary, or control sheet serves a dual purpose. First, to indicate that all time sheets have been received, and second to act as a control of the posting to the clients' ledger sheets.

For each client served, there is opened a cost and billing control ledger sheet, an example of which is included below. This page,

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headed with the client's name and address, may also indicate the fiscal closing date, the fee, the billing basis, the person or entity to whom the bill is to be addressed, and other pertinent information. The body of this sheet provides (reading from left to right) columns for name of auditor, month audited or descrip-

tion of work done, hours by time sheet period (usually weekly or semi-monthly), total hours for each month, date billed, work billed for, amount of bill, date paid and amount paid. A space may be provided on the right for accumulation of traveling or other expenses, remarks as to collection efforts, or other desirable data.

Billing Basis—Monthly					Client—John Jones & Co. Inc.				
Audit Retainer—\$100 per month					Address—333 West 45th Street				
Tax Retainer—\$50 for personal tax returns					City—New York				
Fiscal Closing Date—December 31					Head of Firm—Mr. John Jones				
					Bookkeeper—Miss Grace Smith				
Auditor	Work Done	WEEKLY HOURS					BILLED		PAID
		1	2	3	4	5	Bill Number	Work Billed For	
		Total Hours					Date	Amount	Date
		(October 1940)							
A. Doe	Sep. audit			7	14				
R. Roe	Sep. detail			10	14	45	Oct. 31	A96	Sep. \$100.00
		(November 1940)							
A. Doe	Oct. audit			23					
J. Richards	Oct. detail			20			Nov. 20	A109	100.00
B. Smith	Special—re: system			8		51	Nov. 30	A140	Oct. Special system 25.00
		(December 1940)							
A. Doe	Nov. audit			25					
R. Roe	Nov. detail			18		43	Dec. 25	A196	Nov. 100.00

After the time sheet extensions and footings are checked, the total productive and nonproductive hours are posted to the summary control sheet, and the auditor's name and the applicable hours are posted to the respective client's sheet.

At the end of the month the hours spent during that month, as posted, are totaled and extended on each client's sheet and an adding machine total thereof is compared with the sum indicated on the summary or control sheet. These totals should, of course, be in agreement.

Billing:

Once or twice a month each client's sheet is scanned and a list of bills is prepared. It is simple to see at a glance which work has not been billed and which prior bills have not yet been paid.

Summary:

For the smaller firm, this basic record, therefore, insures that all work done will be billed, affords a

simple accounts receivable record and offers a rapid comparison of time spent and fee charged.

Since he is vitally concerned with time, the practitioner will no doubt ask, "how much time does the proper maintenance of this record require?" Based upon actual experience, I can state that using weekly time sheets for a staff of ten men, one hour per week is required to post all the time information to the control and clients' sheets, and a staff of fifty men necessitates less than one day's posting time per week. Once a month the control can be balanced within three to six hours, depending upon the number of active clients.

Cash Records:

The daily cash collections of the small firm may be listed on the back of the checkbook stubs, indicating name of client or other source, and amount received. The disbursements which should be by check, are explained in detail on the check stubs. Minor expense items will be paid out of an imprest petty cash fund.

It may be found convenient and time-saving to establish a separate payroll bank account or checkbook and to pay employees every two weeks, by check, rather than weekly by cash.

During, or at the end of, the month the receipts and disbursements should be posted from the checkbook to a columnar cashbook. The monthly totals are posted to general ledger accounts, and a trial balance obtained.

Detailed Cost System:

Approximately one-third of the firms replying to our questionnaire reported that profit and loss is computed for each engagement. It is a simple matter to amplify the system just described to arrive at a cost figure for each engagement. It should be understood, however, that the cost of an accounting engagement includes more than the time of the staff man.

Some practitioners base their cost only upon "direct costs"; however, their definitions of direct cost vary from one which comprises only direct staff time, to one which includes the time of staff men, typists, checkers, reviewers, comparers and partners. Whichever basis is used, the direct cost may be accumulated by means of time sheets filled out by each person or department involved.

Indirect costs, however, present a greater problem, since they involve two questions; first, what expense items to include, and second, how to distribute the total expense or overhead thus arrived at.

I will outline a simple, yet accurate, system kept up to date by annual revision of the overhead cost figure, stated at a cost rate per hour.

In order to determine the hourly rate for each class of staff man, the staff is segregated into groups, such as junior, semi-senior, senior, partner and office, based upon rate of pay received and type of work done.

The average present rate of weekly pay for each of the foregoing classes is divided by the average weekly hours of *productive* work for the past year (not by the total weekly hours which would include unassigned time) and the *basic hourly cost rate* is thus obtained.

The *overhead cost rate* is arrived at as follows:

(a) Total the actual expenses for the past fiscal year (excluding productive salaries); these expenses include rent, light and phone, stationery, tax services and accounting texts and periodicals, carfares, postage, supper money, depreciation of office furniture and equipment, traveling expenses not reimbursed by clients, etc.

(b) Increase or decrease this figure by known variations to be encountered during the coming year, such as new rental under lease terms, additional subscriptions or services, etc.

(c) The total expense thus obtained is divided by the total *productive* hours worked during the past year by the whole staff. This will give the overhead cost per direct labor hour.

After the time sheets are handed in by the staff, two figures are recorded in the corner; the basic hourly cost rate for the class of man involved and the hourly overhead cost. These figures are added to arrive at the total cost rate each productive hour must bear.

Two columns headed "for office use only" appear on the right-hand side of the time sheet previously described. In the inner column, opposite the total hours entered for a particular client, is recorded the total hourly cost rate. This figure is multiplied by the total hours, to arrive at the dollar cost of the work done for each client.

This dollar cost is posted to the cost and billing control ledger sheet

explained earlier in this talk, which, for this purpose, is amplified by inserting dollar cost columns immediately after the total hours' column on said form.

Results Obtained:

On one ledger sheet, which does not exceed 11 by 16 inches in size, we now have (with a minimum of time-consuming posting labor) the following information:

- (a) The name of each man who worked on the engagement.

This is helpful as a guide in rotating men on audits.

- (b) A description of the work done.

This will help the supervisor or manager spot excessive time resulting from conferences, special services, tax matters, etc.

- (c) The time, in hours, consumed by the engagement.

This is a valuable guide in comparing the monthly and annual time with the predetermined estimate when the fee was set.

- (d) The cost of the work done.

This affords a quick comparison with the billed amount in the next column and will indicate at a glance profitable and unprofitable engagements.

- (e) The date, description and amount of each bill sent the client.

- (f) The date and amounts paid.

These columns are the account receivable record of the firm; afford a running record of the balance due at any date; and assure that all work done will be billed for.

The ledger sheets should be reviewed monthly by the administrative partner of the accounting firm

and the aforementioned information should be studied in order to eliminate unprofitable engagements (if fee increases cannot be obtained); to see that proper staff rotation is carried out; and to avoid the accumulation of account receivable balances.

Staff Time Record by Individuals:

A further addition to the basic system just described, may comprise a cumulative time record for each staff man. This may be obtained by posting each time sheet's total hours (differentiating between productive and idle time) to an individual ledger sheet, bearing each man's full name and his staff rating (i.e., junior, semi-senior or senior). This staff rating will be reviewed yearly for purposes of revision if warranted by the type of work presently handled by the man.

In series of four columns extending across the sheet will be spaces for (a) the date the week or time sheet period ended, (b) productive hours, (c) idle time, and (d) total hours. A year's time can thus be set forth on one sheet.

Idle time resulting from illness, time-off and vacations should be appropriately indicated.

Control of Idle Time:

At any time during the year, by totaling the periodic hours as recorded, you arrive at the productive and idle hours of a specific staff man as compared to the average staff hours or to the hours of another staff man and by continuing this record over a period of years interesting studies as to time lost by illness or other causes may be evolved. However, the most important result of this form is the record it affords of idle and unassigned time.

Idle time, a major expense in most accounting practices, can sometimes be alleviated by study and revision of the program and assignments of

the various staff men. It is also suggested that much of the detailed work in connection with annual or semi-annual audits be done during, instead of at the end of, the respective period. The interim work which can thus be done comprises vouching purchases, bank reconciliations, building workpaper schedules, review of internal control, payroll auditing, etc.

When, despite the foregoing attempts, men are available at the office, they can be utilized to fill in the prior year's comparative figures on the financial statement forms to be used on subsequent audits. Incidentally, it will be found economical to have report outlines and statement forms typed in advance by the typing department during its slow periods.

Control of Staff Assignments:

The assignments and work of a staff ranging from ten to fifty men, engaged mainly on monthly or interim audits, can be controlled efficiently by the use of one basic and simple form.

At the beginning of each month the administrative partner or office manager, lists down the left-hand side of a ruled sheet, the name of each staff man, in alphabetical order. Across the top of the sheet are recorded the days of the month. Opposite each staff man's name, in the order

the work is usually done, are entered the names of the clients he is to visit during the coming month. The client's name is written so as to spread over the number of days the work is expected to take.

From the blank spaces may be estimated the unassigned time for the month and a use therefor planned. This sheet also indicates which men will have light programs, and thus be available for special work which arises.

As the client's office informs the accountant that the books are ready for audit, a red dash is entered on the aforementioned sheet in the space where that client's name is recorded. The manager can thus rearrange the order of work if necessary to service those clients who are ready for audit.

When the engagement is completed the respective space is lightly shaded over in pencil. The progress of the shaded areas will indicate what work has been done.

Conclusion:

In conclusion, let me again state that while the methods outlined herein for purposes of illustration may not be applicable to every office, the purpose of this paper has been served if your thoughts have been directed towards the important problems of procedure in your offices.

Liability and Other Types of Insurance for Accountants

By RAY R. DOBSON, C.P.A.

ACCOUNTANTS are continually reviewing the insurance coverage carried by their clients as part of their regular audit procedure. I believe it is also essential for accountants to review their own insurance coverage as there are certain types of insurance that it would be well for them to carry for their own protection. In discussing such coverage I have divided the forms of insurance in which accountants should be interested into two groups. First, insurance that most prudent businessmen carry, and second, insurance protection that is especially adapted to accountants.

In the first group I have included the following forms of coverage:

- Fire
- Sprinkler leakage
- Robbery, including payroll hold-up
- Forgery
- Automobile liability and property damage insurance and non-ownership coverage
- Workmen's compensation
- Public liability

The second group contains the following forms of insurance:

- Life insurance carried on partners' lives
- Insurance on working papers
- Accountants' liability insurance
- Fidelity bonds
- Group life insurance and pension plans

There are, of course, other forms of insurance which might be carried in special cases, but the foregoing

forms include those in which accountants are or should be primarily interested.

I will not discuss in detail the advantages of the forms of insurance included in the first group as you are all familiar with them. However, I do want to make a few observations relative thereto.

The ordinary fire insurance policy covering furniture, fixtures, equipment, and working papers of an accountant does not cover the accountant's property if it is destroyed by fire in a client's office. A special floater policy is available, however, which covers such a loss.

I have placed automobile liability and property damage insurance in the first group. If the partners and the employees use their cars in connection with the business and an accident occurs, the accounting firm may find itself involved in a lawsuit. Where cars are used, the firm should make certain the coverage carried on each car is adequate and that the policies are in full force and effect. If the firm is not sufficiently protected, excess or contingent coverage can be placed. The rates for such coverage are usually nominal. Adequate coverage is essential today since accidents are so prevalent. Even a careful driver, through no fault of his own, may become involved. I am certain that anyone here who was ever involved in an accident will agree with me that it is always the other fellow's fault. However, damages awarded by courts are often high and may seriously impair the capital of a small firm.

Presented at the Eighteenth Annual Fall Conference of The New York State Society of Certified Public Accountants held at the Waldorf Astoria Hotel on October 7, 1940.

That can happen here, and to many of us, if insurance is not carried.

The New York State law requires employers having more than four employes, engaged in a hazardous occupation, to carry workmen's compensation insurance. Some accounting firms consider the work of accountants hazardous and carry workmen's compensation insurance, while other firms feel it is not hazardous and do not carry such insurance. I, personally, recommend that accountants carry workmen's compensation insurance. If one of your employes should be injured while taking an inventory, for example, it might be rather difficult to prove that the occupation is not a hazardous one.

Public liability insurance protects the firm from damages arising from injuries sustained by outsiders on the firm's premises.

I will now discuss the second group, which contains the forms of insurance that are especially adapted to accountants.

Insurance on the lives of partners is placed in this group because accounting firms are usually partnerships. Unless some provision is made for the continuance of a firm, the death of a principal partner may cause considerable financial embarrassment. The interest of the deceased partner must be liquidated and working capital must be available for the remaining partner, or partners, to carry on. I believe that the practice of insuring the lives of partners has had a great deal to do with the growth and continuance of many firms.

Insurance on working papers is aptly described by its name. It covers the working papers used by accountants in preparing reports for the firm's clients. These papers are valuable and if they are lost or damaged, the firm will be put to considerable expense, if it is necessary to replace them. Such papers can

be insured anywhere in the United States and Canada against practically all risks.

Such insurance can be arranged for any total amount desired, subject to limits, somewhat as follows:

- \$1,000.00 on any one audit
- 1,000.00 in the custody of any one accountant
- 100.00 on any one paper

The annual premium is based upon the exact amount of these limits, the total amount of insurance required, and whether or not automobiles are used by the auditors to an extent that there is a considerable hazard of theft from unattended cars. For a hypothetical case, if \$15,000.00 insurance is desired with limits somewhat as aforementioned, the premium will be around \$150.00. If \$100,000.00 insurance is desired with the same limits and with not more than 100 auditors employed, the premium might be \$500.00 per year.

The insurance on any one set of working papers is in effect until the related report has been prepared and sent to the client and the coverage on any one set of papers on the firm's premises is for not more than thirty days or until the report thereon has been prepared.

We come now to the one form of insurance that accountants only are interested in, namely, accountants' liability insurance.

The accountants' liability insurance policy protects the accounting firm from pecuniary loss and/or expense arising from any claim made against the accounting firm for damages caused or alleged to have been caused by the neglect, error or omission of any partner or employee of the accounting firm in the performance of services rendered in its professional capacity for any person, firm, or corporation by whom the accounting firm has been employed.

The basic minimum policy is for

\$20,000.00. The annual premium on such a policy depends on the number of people in the employ of the insured. The annual premium on a \$20,000.00 policy is approximately as follows:

For Insureds having 2 employees..	\$ 60.00
For Insureds having 5 employees..	75.00
For Insureds having 10 employees..	100.00
For Insureds having 25 employees..	175.00

Insurance coverage of less than \$100,000.00 under this form of insurance must be purchased in multiples of \$20,000.00. The annual premium on coverage in excess of \$20,000.00 is as follows:

2nd \$20,000.00, 60% of the premium for the first.....	\$20,000.00
3rd 20,000.00, 40% of the premium for the first.....	20,000.00
4th 20,000.00, 30% of the premium for the first.....	20,000.00
5th 20,000.00, 20% of the premium for the first.....	20,000.00
For each additional \$10,000.00 in excess of \$100,000.00, the annual premium is 5% of the premium for the first \$20,000.00.	

The annual premium on a policy for \$100,000.00 is approximately as follows:

For Insureds having 2 employees..	\$150.00
For Insureds having 5 employees..	187.50
For Insureds having 10 employees..	250.00
For Insureds having 25 employees..	437.50

In the event an accounting firm assumes the first \$500.00 of loss, under a deductible loss provision, the annual premiums on the policies as given in the aforementioned examples are subject to a 10% discount.

A rider can be attached to the policy which covers the accounting firm's legal liability for damages arising from any dishonesty or misstatement or fraud on the part of its employees. The addition of this rider increases the cost of the policy by an amount equal to 50% of the basic annual premium.

If the accounting firm has its accountants' liability insurance policy extended to give coverage against liability under the National "Securities Act of 1933" an additional pre-

mium charge of 50% is added to the basic annual premium.

The accountants' liability insurance policy may also be extended to cover branch offices by payment of an additional charge of \$2.00 per employee with a minimum of \$10.00 per branch office.

The policy may be extended to cover work delegated to outside accounting firms by payment of a flat charge of \$20.00 per firm.

The deposit premium on the accountants' liability insurance policy is subject to revision at the termination of the policy year when the accounting firm furnishes the company a written declaration stating the maximum number of persons and the minimum number of persons engaged in the firm's service during each month of the policy year. If the firm has liability coverage under the Securities Act and it did not file any reports thereunder during the policy year, it is entitled to a refund of 50% of the premium charged for such coverage.

The American Institute of Accountants recognized sixteen years ago that a need for accountants' liability insurance existed, for it had a committee at that time to investigate the policies offered by indemnity companies for the protection of accountants. The report submitted by that committee in 1924 was as follows:

- "1. The committee recommends that members of the Institute in public practice cover themselves with some form of indemnity insurance.
- "2. There has been a feeling on the part of some accountants that the matter is one which should not be made public. The committee is of the opinion that the danger of any detrimental effect is remote. Nevertheless, little good is to be gained by publicity.

- "3. It is not likely that any American company will write this form of insurance unless it can be sure of a reasonable amount of business. The committee, therefore, recommends that a questionnaire be sent to members in order to ascertain the probable amount of insurance which might be written and also ask for a commitment running for, say, three years, to the first one or two companies which will write a satisfactory policy, after which they will be free to place their insurance as they like.

"Respectfully submitted for the committee,

"Robert H. Montgomery,
chairman

F. H. Hurdman
E. G. Shorrock
C. R. Whitworth"

That such insurance is needed today is evidenced by an article written by Richard T. Wood, of the American Surety Company of New York, on accountants' liability insurance, in which he states as follows:

"It may be interesting to see the kind of claims which have been presented to us under this type of policy. These are thumbnail sketches without sufficient detail to identify the Insured in any case. They are given to show the practical application of the professional hazard to which you are exposed.

"(a) Claim made because of irregularities in the accounts of one of the employees of a client *not* brought to light as a result of examination by the Insured's agents.

"(b) Claim made because of misappropriations of a bookkeeper of a client, which misappropriations were not discovered, thereby causing client a loss in excess of

the amount of bond carried on the bookkeeper.

"(c) Claim made for damage to reputation by employee of a client, which employee was discharged on the strength of a report of examination by the Insured.

"(d) Claim made alleging that Insured had prepared published reports which contained misleading facts and omitted material facts.

"(e) Claim made because balance sheet audit of client did not bring to light a defalcation by an official of the client who thereafter continued to embezzle until subsequently discovered.

"(f) Claim made by creditor of a client because credit had been extended on strength of an audit report by the Insured which did not disclose a defalcation on the part of an officer of the client.

"(g) Claim made because Insured inadvertently made mistake in preparing Federal tax returns of client.

"(h) Claim made because report of Insured was alleged to have hampered client in carrying on business and greatly injured client's credit and financial reputation. Client attached several bank accounts of the Insured plus the personal accounts of the various partners.

"(i) Claim made because defalcation of bookkeeper of client was not discovered by the Insured.

"(j) Claim made because shortage in accounts of a public official was not disclosed by the audit of the Insured."

In view of the foregoing and the increasing tendency on the part of the Courts to award damages for negligence, etc., against accountants, I believe it is necessary for all firms to carry accountants' liability insurance. However, let's not depend on

it too strongly ; instead, let's do such a good job that we won't need it.

Fidelity insurance is to protect the firm from any dishonesty on the part of its employees. This protection may be provided by individual bonds, a schedule bond, or a blanket bond with retroactive restoration, so that the firm is protected at all times. There is a special rider for fidelity bonds sold to accounting firms, which is added without additional cost, that provides as follows :

"That the attached bond shall be construed to cover any direct loss or losses which any person, firm, corporation or association for which the services of the Employer have been engaged for audit purposes shall sustain, of money or other personal property belonging to such person, firm, corporation or association or in which such person, firm, corporation or association has a pecuniary interest, or which is held by such person, firm, corporation or association as collateral or as bailee, trustee or agent, through larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wilful misapplication, or other fraudulent or dishonest act or acts committed by any one or more of the Employees acting directly or in collusion with others, during the period of such audit and while the attached bond is in force as to the Employee or Employees causing such loss or losses."

It is interesting to note, in this connection, that some authorities estimate that the total annual em-

bezzlements in the United States exceed the total annual fire losses, yet uninsured fire losses in recent years are estimated to have averaged only 10% of the total fire losses ; whereas, uninsured embezzlement losses are estimated to have averaged 90% of the total embezzlement losses.

Group life insurance and pension plans are just as valuable to accountants as to any other business, but, of course, it is not necessary that they be carried in order to have a successful accounting business. They may be a factor, however, in promoting the morale of an organization. It is for that reason that I mention them here. Many large firms have deemed it expedient to purchase this type of insurance. There are many arrangements that can be worked out in this field. The firm may carry group life insurance on the lives of all employees and pay the entire cost or it may pay part of the cost and the employee part. Or the firm may pay for a certain amount and the employee may be permitted to contribute toward the cost of additional coverage if he so desires. Each firm should make the arrangements that best fit its needs.

In this paper I have merely tried to point out the principal forms of insurance available to accountants ; therefore, I have been more or less general in my remarks. I do not believe that accountants should attempt to pass on the finer points of insurance and I recommend that you review your own coverage and particular problems with a competent insurance broker. This course will insure that you have the proper coverage and may also save you money.

Some Significant Federal Tax Decisions and Rulings in 1940

By NATHANIEL B. BERGMAN, C.P.A.

THE mass of unsettled tax questions is bringing forth daily interpretations in the form of rulings and court decisions. Many basic problems appear to have been resolved when, in fact, the confusion has been increased. The Bureau has revoked certain rulings which formed the basis of claims and procedures. It is obviously unnecessary to do more than review a few of the developments in the year, since any attempt to do otherwise would entail the compilation of references which are covered in more complete form in published material available to those interested.

As an indication of some of the important questions to be passed on, the following cases are before the Supreme Court on writ of certiorari:

Corporate Charter as Contract: Whether corporate charter is a contract for the purpose of the provisions of Sec. 26(c)(1), 1936 Act, as to credit for contracts restricting payment of dividends (*Crane-Johnson Co. v. Commissioner*, 105 Fed. (2d) 740).

Bond Retirement: Whether surrender of bonds in connection with refinancing is to be considered a retirement under Sec. 117(b), 1934 Act. (*Thomson v. Helvering*, 108 Fed. (2d) 642; *McClain v. Commissioner*, 110 Fed. (2d) 878).

Capital Losses on Joint Return: Court must pass on whether capital losses can be offset against wife's capital gains in a joint return under 1934 Act (*Helvering v. Janney, et al.*, 108 Fed. (2d) 564).

Foreclosure Loss: Issue is whether loss on sale of property by

foreclosure is a capital loss (*Electro-Chemical Engraving Co., Inc. v. Commissioner*, 110 Fed. (2d) 614); *Commissioner v. Hammel, et al.*, 108 Fed. (2d) 753).

Noncapital Security Gains and Losses: Whether partnership non-capital security gains may be offset against the partners' individual non-capital losses; revolves around the constitutionality of Sec. 23(r), 1932 Act (*Neuberger v. Commissioner*, 104 Fed. (2d) 649).

Gift of Bond Coupons: The issue is whether income of owner of bonds should include coupons detached and given away before maturity (*Helvering v. Horst*, 107 Fed. (2d) 906).

It is superfluous to state that in the train of the Excess Profits Act of 1940 will follow a new line of decisions and a line of new decisions.

Inclusion in Gross Estate of Certain Trusts: In *Helvering v. St. Louis Union Tr. Co.* (296 U. S. 39) the Supreme Court held that in case of a gift made in trust with a provision that the corpus should revert to the grantor if the beneficiary predeceased him, the corpus was not part of the grantor's estate if he predeceased the beneficiary. In the *Hallock* decision (60 S. Ct. 444) it was held that the gross estate of a decedent includes property transferred by him by *inter vivos* trust where the agreement provided that the trust property should become the grantor's if the beneficiary predeceased the grantor. By reason of the reversionary interest which he retained, where the beneficiary survives the grantor the trust property is included in the grantor's gross estate as a transfer "intended to

take effect in possession and enjoyment at or after his death." The Court relied on its earlier decision in *Klein v. U. S.*, 2 USTC Para. 706, 283 U. S. 231, and rejected the principle in *St. Louis Union Tr. Co.*

It might be read into the *Hallock* decision that the possibility of reverter relieves the transfer from the gift tax and if a gift tax were paid when the trust was created a refund claim might be filed based on that part of the value of the gift represented by the possibility of reverter. The matter will have to be clarified, probably by Congress.

Dividend in Nonvoting Stock Paid on Voting Common, Held Taxable: This Board decision (John M. Keister, 42 B.T.A. No. 74) on the authority of *Koshland* (298 U. S. 441) is of particular interest. The Board's reasoning is set out in the following:

We think that under the opinion of the Supreme Court in the *Koshland* case the petitioners who received on their voting common stock a dividend of nonvoting common shares received a taxable dividend. The nonvoting common stock was not "of precisely the same character" as the stock previously held by them. By the receipt of the dividend each holder of voting common stock received an "interest different from that which its former stockholdings represented." In making this observation we do not overlook the fact that the value of the additional nonvoting common shares received was presumably no greater than a like number of voting common shares which would not be subject to income tax under the opinion in *Eisner v. Macomber*, *supra*. Probably the shares had a less value. But the interest was different, and we think that is all that is required to make the dividend taxable to the holders of voting common stock.

As a dividend of common on common there should be no tax on the authority of *Eisner v. Macomber* (252 U. S. 189).

Bad Debts Charged Off Mentally:

In an unusual decision (*H. E. Cammack*, C.C.A. 8) the Court allowed a deduction for bad debts on the ground that while there had been no actual write-off (which was the reason for the denial of a refund by the Commissioner and the District Court for the District of Minnesota) there had been a mental write-off. The reason why certain notes had not been written off was that in the year in which they became bad the taxpayer had been advised that the Commissioner would not allow the deduction. The Court cited *Collin v. Commissioner* (1 B.T.A. 305) as follows:

The connotation is irresistible that in using the words "charged off" Congress referred to that which had been charged on. We do not believe that any other construction would be tenable, nor do we believe that in so reading the statute there has been grafted on the statute any provision beyond the clear import of the language used.

The mechanical process of keeping accounts is not prescribed by statute. Such accounts may be recorded in an elaborate set of books, or in mere memoranda, or be recorded only in the brain of the taxpayer. It can make no difference as to the form of such operation.

Basis of Oil Property: In line with a previous interpretation under the 1936 law, the Bureau holds that basis for gain or loss on a sale in 1939 of developed oil property the capital account should be reduced by the excess over the original basis of percentage depletion deductions allowed in years prior to the drilling

of an additional well in 1938 (G.C.M. 22239; 1940-35-10400).

"Hedging" Transactions Held Not Capital Losses: In a review of its decision, the Board rendered an opinion (41 B.T.A. 1083) superseding its previous opinion in *Farmers and Ginners Cotton Oil Company* (41 B.T.A. 255) holding that losses on "hedgies" were ordinary losses and four members dissented. They had decided similarly in *Grote* (41 B.T.A. 247). One of the dissenting members who said that the transactions in this case were not true hedgies went on as follows:

"Hedging 'is a means by which collectors and exporters of grain or other products, and manufacturers who make contracts in advance for the sale of their goods, secure themselves against the fluctuations of the market by counter contracts for the purchase or sale, as the case may be, of an equal quantity of the product, or of the material of manufacture.' Board of Trade v. Christie Grain & Stock Co. 198 U. S. 236, 249. In *U. S. v. Coffee Exchange* 263 U. S. 611, 619, the Court refers to one of the classes who deal in 'futures' as 'those who use them to hedge, i.e., to insure themselves against loss by unfavorable changes in price at the time of actual delivery of what they have to sell or buy in their business.' The examples given in the G.C.M. (17322) indicate that when the Commissioner used therein the term 'hedging' he had in mind the Court's definition. I would limit the applicability of the ruling to one who has made a counter contract for the purchase or sale of an equal quantity of the product manufactured or raised, or of the material going into the manufacture of it."

Basis of Property after Bankruptcy: Sections 270, 396 and 522

of the Bankruptcy Act were amended to limit the reduction of the basis of property (other than money) of the debtor or his transferee to the fair market value of the property as of the date of the entry of the order confirming the bankruptcy arrangement (T.D. 5003). Prior to amendment, the basis had to be reduced by the amount cancelled or reduced in the bankruptcy proceeding.

Deduction of Real Estate Taxes:

One parcel of New Jersey real estate was purchased on October 16, 1933 and another on January 8, 1934. Date of assessment for 1934 was October 1, 1933. Purchaser on cash basis was allowed deduction for the taxes except as to taxes applicable to the period, January 1-8, 1934. Under New Jersey law the buyer may hold the seller liable for taxes due in a current year, proportioned as to the period that January 1 to date of sale is to current year (C.C.A. 3; 110 Fed. (2d) 725). The court said:

So the fact that the property has been assessed prior to sale, does not in the eyes of the New Jersey legislature, mean that the tax resulting from that assessment is to be borne by the seller. It is always borne by the land in the first instance. But as between buyer and seller it is apportioned on the basis of the calendar year. In other words, it is considered fair that the owner of land in any given year shall be called upon to contribute to the year's revenues only a sum commensurate with the length of time the land has been held in that year—except of course, in the rare case of the prior owner's insolvency.

No More Green Copies of Returns:

Green copies of income tax returns will not have to be furnished for taxable years beginning after December 31, 1939 (T.D. 4989 July 15, 1940).

Retroactive Taxation: The constitutionality of retroactive income tax provisions has been passed on. An example of hardship in this connection is found in a recent board decision (Prudential Tobacco Co., Inc.; 42 BTA, No. 80 Aug. 13, 1940).

A taxpayer on a calendar year changed to a fiscal year March 31 and filed a return for the three months ended March 31, 1936. The 1936 Act was passed June 22, 1936 and under its provisions taxpayer had to pay undistributed profits tax for the three months. It is of interest to read a note of doubt in the decision (underscoring supplied).

Had it remained upon a calendar year basis all of the provisions of the Revenue Act of 1936 would have applied to its 1936 income. The filing of a return, on or before June 15, 1936, for the short period, was one of the conditions upon which permission for the change was granted. Failure to file the return would have left the petitioner upon the calendar year basis. Perhaps an answer to the petitioner is that it must take the disadvantages of the short period along with the advantages which it sought . . . *While we are not entirely free from doubt upon the present question, nevertheless, we are unwilling to declare it unconstitutional upon the present record.*

Bad Debt Recoveries: In G.C.M. 22163-1940-28-10324, the Bureau has in effect reversed its prior position that bad debt recoveries were not taxable if they had been deducted in a return which indicated a statutory net loss. The authorities cited for the change of position are Burnet v. Sanford & Brooks Co. (282 U. S. 359) and U. S. v. Ludey (274 U. S. 295).

G.C.M. 18525 (C. B. 1937-1, 80) modified; G.C.M. 20854 (C.B. 1939-1 (Part 1), 102) revoked; and S.R.

2940 (C.B. IV-1, 129 (1925) 102) modified. Recommended that I.T. 3172 (C.B. 1938-1, 150) and I.T. 3256 (C.B. 1939-1 (Part 1), 172) be revoked; that I.T. 3278 (C.B. 1939-1 (Part 1), 76) be modified; and that the acquiescence in Central Loan & Investment Co. v. Commissioner (39 B.T.A., 981, acquiescence, C.B. 1939-2, 6) and the acquiescence in The National Bank of Commerce of Seattle v. Commissioner (40 B.T.A., 72, acquiescence C.B. 1939-2, 26) be withdrawn.

Absence from U. S. Over Six Months: The law permits a citizen of the U. S. who is absent from the U. S. for more than six months to exclude from taxable income salary earned during his absence. G.C.M. 22065 (1940-24) is to the effect that the law contemplates calendar months and that while the six months do not have to be continuous, parts of months may not be included to make a full calendar month. For example, absence from March 10 to April 17 is to be treated as one calendar month, but absence from March 10 to April 5 would not be counted at all. G.C.M. 12167 (CB XII-2, 126) is modified accordingly. See also G.C.M. 9848 (C.B. X-2, 178).

Corporate Contribution of Compensation Refused by an Employee: A corporation voted an officer special compensation which he refused, but directed that an identical amount be paid to a state university. The Board held that the amount was not income to the officer and did not question the corporation's right to make the donation (Giannini v. Commissioner; 42 BTA 607).

Identification of Shares Sold: The Supreme Court held in *Helvering v. Rankin* (295 U. S. 123) that in the case of margin lots identification was supplied if a trader designated the securities to be sold as those purchased

on a particular day and at a particular price. The question came up again in *Harry F. Canelo* (41 B.T.A. No. 99) who had several accounts with a broker and whose method of selling was to tell the broker which shares to sell and later to instruct the broker to credit the proceeds to a particular account with the broker. The Board upheld the Commissioner who had applied the first-in, first-out rule on the ground that the shares sold could not be identified with any specific purchase. In order to get the maximum tax benefit, care should be taken that there is identification or if that cannot be done, that the first-in, first-out rule has been applied.

Prepaid Subscriptions: The Treasury's position has been that prepaid subscriptions to periodicals must be reported in the year of receipt by a taxpayer on the accrual basis (G.C.M. 20021, 1938-1, C.B. 157). In recent I.T. 3369 (1940-17-10243, P. 3) the Bureau appears to have committed itself to permitting taxpayers to continue to report subscriptions when collected or to spread them, provided however that in the latter case the expenses connected with obtaining the subscriptions or applicable to subscriptions themselves must also be spread in the same manner as the income.

Reorganization under 77-B. No Gain or Loss to Bondholders: Substantially all of the assets of a wholly owned subsidiary were acquired by the parent. The subsidiary's first mortgage bonds outstanding were guaranteed principal and interest by the parent. The bonds were not paid at maturity and under a plan of reorganization under Section 77-B of the Bankruptcy Act, all of the assets of the bankrupt were transferred to a new corporation and bonds and stocks of the latter were issued to the original bondholders who immediately con-

trolled the new company. The Board (five members dissenting) held that gain or loss was not recognizable as this was a statutory reorganization (under Section 112-b-3 of the 1936 Act). The Board stated that its decision was not in conflict with *LeTulle v. Scofield* (308 U. S. 415) since the holders in that case did not retain a proprietary interest in the enterprise (*Newton Trust et al.*, 42 B.T.A. 473).

Uninvested Proceeds of Fire Insurance: The Third Circuit has held that a gain on fire insurance proceeds due to not having been invested in similar property is taxable as capital gain (*William Flaccus Oak Leather Co. v. Commissioner*, C.C.A. 3). The court said that the gain resulted in effect from a "sale or exchange." However, the Court of Appeals for D.C. (*Herder v. Helvering*, 106 F. (2d) 153) decided that such gain was taxable as ordinary gain.

Payment of Legacy With Securities. Capital Gain: A legacy in a fixed amount was paid by the fiduciaries partly in securities upon which a gain was realized. The Second Circuit Court (*Kenan, Jr., et al., Trustees v. Commissioner*) affirmed the Board's decision (40 B.T.A. 823) that capital gain and not ordinary income was realized because the legatee acquired the securities in an exchange and not by "bequest, devise or inheritance." The same circuit had decided another case in the same way and certiorari has been denied by the Supreme Court (*Suisman v. Eaton*, 299 U. S. 573). The principle in this case could, of course, be followed to establish a loss.

Deductibility for Worthlessness of Stock: A taxpayer on the cash basis bought stock on the instalment basis and the court held that he was entitled to deductions for instalments paid after the year in which the stocks became worthless. The court

said that in respect of a taxpayer on the cash basis, the year in which the stock becomes worthless is not controlling for claiming loss (*Tams, Jr. v. U. S.*, D. C. So. Dist. of W. Va., June 18, 1940). In I.T. 3252 the Commissioner had taken the same position as now taken by the Court and his departure from this ruling was, therefore, inconsistent.

Stock Loss in Liquidating Corporation: It has always been a nice question to decide just when a stockholder can get his loss when a corporation is liquidating. The Treasury has never viewed the matter realistically and even though there remained a negligible amount of assets easily valued, it appears to have required that all assets must be distributed before the loss can be claimed. The Bureau took this position in *Commissioner v. Winthrop* (98 Fed. 2d, 74) but was reversed by the court and as a result, its original nonacquiescence was withdrawn and a formal acquiescence was published (see G.C.M. 21966).

Repossession of Real Estate. Loss Allowed: A taxpayer sold realty at a profit. Deferred payments involved in the sale were reported as worth par and entire profit reported. In a subsequent year, property was repossessed without foreclosure and purchaser released from further payment. Deduction was claimed for a loss or a bad debt. Court allowed deduction as a loss. Bad debt disallowed on ground that since parties personally liable were released from liability and property reconveyed to mortgagee there was no longer a debt (*Bowles Lunch Inc., v. U. S. Court of Claims*). Court found nothing in *Midland Mutual Life Insurance Co.* (300 U. S. 216) in conflict with *Bowles*. *Midland* involved a foreclosure sale.

Head of Family: In I.T. 3410 (1940-39-10428) the Bureau responds to a request for an opinion as to what

is embraced in the term "closely connected" as used in Reg. 103, Sec. 19.25-4. The ruling is very broad and will, no doubt, clear up questions hitherto considered doubtful.

Optional Date. Estate Tax Valuation. Interim Income: Art. 11, Reg. 80, requires that income after date of decedent's death is to be added to the gross estate where estate elects to value its assets as of one year after decedent's death. In *Clark, Exr. v. U. S.*, Maryland District Court held against the requirement. The Second Circuit Court in *Saks et al., Exrs. v. Higgins* has upheld the Commissioner (111 Fed. (2d) 78). The Board upheld the Commissioner in *Abendroth Est.*, 41 B.T.A. No. 156, but four members dissented.

In the *Saks* case, Judge Chase (dissenting) said:

But if Congress did intend to do what Art. 11 of T.R. 80 provides, and the majority has held the statute means, it chose a strange way to do it. Had that been the intention of Congress, it would have been easy to have said in plain words that that was one of the conditions attached to the option given. Because it did not do so but on the contrary simply provided that an executor might have the property in the estate at death valued as of a year later instead of taking the valuation as of the date of death, I think the ordinary distinction which is recognized throughout the income and estate taxing statutes between what is usually regarded as income as distinguished from principal was intended to be maintained. It follows that I cannot accept the abstract reasoning of the regulation which the majority opinion approves as a permissible interpretation of a statute relating to taxation where the ordinary meaning of the language used is to be given effect.

It is safe to say that the issue cannot be said to be finally settled.

Deductibility of State Income Tax by State and Municipal Employees: In I.T. 3406 an illustration is given of the basis for allocation of state income tax to compensation not taxable under Public Salary Act of 1939. This will probably be of interest chiefly as to 1939 returns. The formula allocates the tax to the total *nontaxable* and total *taxable* income respectively after deducting from each the expenses which are directly applicable thereto.

Gain from Improvements by Lessee: The Supreme Court in a *per curiam* opinion (*Helvering v. Wood, Jr., et al.*, 60 S. Ct. 897) held that gain was realized by a lessor when he acquired as a result of default by the lessee improvements made by the latter. This was in line with *Helvering v. Bruun* (112 Fed. (2d) 573). In *Helvering v. Bruun* (60 S. Ct. 631) the Supreme Court held that income was realized by lessor when the lessee defaulted and the land and building (the latter erected by lessee to replace an old one) became the lessor's. To the taxpayer's contention that the enhancement resulting from the improvements was not income within the meaning of the Sixteenth Amendment, the Supreme Court held that the definition of income in the law may include property if the value thereof is ascertainable. The Court said:

Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas

such gain has always been recognized as realized taxable gain.

Mortgage Foreclosure: The First Circuit allowed a loss where taxpayer-mortgagee bid in the property for an amount equal to the face of the mortgage, but in excess of the value of the property (*Hadley Falls Trust Co. v. U. S.*, 110 Fed. (2d) 887). Despite the regulations under which the fair market value is presumed to be the amount bid in by the taxpayer, a lesser amount was recognized. This may appear to be inconsistent with *Helvering v. Midland Mutual Life Insurance Co.* (300 U. S. 216) where the Supreme Court regarded as of no consequence the contention that the property was worth less than the principal of the debt.

The First Circuit denied a loss in another case (*Malden Tr. Co. v. Commissioner*, 110 Fed. (2d) 751) because it was not shown that the fair market value was less than the amount of the bid price. A deduction was disallowed for a bad debt because there was not a statutory charge-off. There was a transfer on the books from "loans on real estate" to "foreclosed real estate." The court said "taxpayer must eliminate the debt as an asset on its books in order to comply with the statutory requirements of charge-off."

Debt Paid by Note: Under a guaranty agreement, taxpayer on a cash basis gave his note which was secured by collateral. He was denied a loss by the Supreme Court because the note was held not to be the equivalent of cash and hence not a payment (*Helvering v. Price*, 60 S. Ct. 673).

Credit for Unborn Child: The Board held that during the period prior to the birth of a child, an unborn child was not a "person" within the meaning of the Act and hence no credit for dependents was al-

lowed for that period. (*Wilson, et al.*, 41 B.T.A. No. 66).

Short-term Trusts: The Supreme Court held in a case involving a short-term trust that the grantor was taxable on the income (*Helvering v. Clifford*, 60 S. Ct. 554). The short duration of the trust, the fact that the wife was the beneficiary and the retention of control over the corpus were the factors which seem to have decided the case. As to retention of control, the court stated the basic issue to be whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner. The term was for five years, but terminable under certain events at an earlier date; grantor was trustee and had wide powers of control. The decision does not affect all short-term trusts; it does concentrate on the degree of control retained by grantor.

In another case (*Helvering v. Wood*, 60 S. Ct. 807) the Supreme Court denied the Commissioner the right to tax the grantor of a short-term trust under the provision of law relating to revocable trusts. The inference is that if the tax had originally been asserted under Sec. 22(a), the decision might be the same as the *Clifford* decision.

Section 102: In two cases involving alleged improper accumulation of income to avoid surtaxes the Board has decided against the Commissioner in respect to Section 104 of prior laws (corresponding to Sec. 102 in the present law). *Corporate Investment Co.*, 40 B.T.A. 1156, in this case there was a contract with a stockholder which delayed receipt of dividend to him. In the second case, in order to aid an operating company, a holding company was formed and a transfer made of surplus (*Delaware Terminal Corp.*, 40 B.T.A. 1180).

Federal Taxation of Incomes of Nonresident Aliens and Foreign Corporations

By FRANK S. HARMAN, C.P.A.

THE war has to a large extent eliminated financial and commercial transactions in this country by residents of many foreign countries. Nevertheless, aliens still possess a vast quantity of American securities, the income from which is subject to American income taxes and, as is well known, nonresident aliens are very tax conscious individuals. Many prominent foreign commercial and financial institutions have, since the war, sent representatives to this country and in addition, many nonresident alien individuals have taken temporary refuge here, not a few of whom are wealthy. As a result, there is increased interest in the Federal taxation of alien individuals and foreign corporations, a subject with which accountants should be familiar. The following article is not intended to cover the subject in its entirety, but merely to summarize the more important points.

A nonresident alien individual is one (a) who is not a citizen of the United States, and (b) whose residence is not within the United States. An alien is presumed to be nonresident because of his alienage. However, such presumption may be overcome by proof to the contrary. Proof that the alien has filed a declaration of his intention to become a citizen, or proof that such alien has filed Form 1078, which form is designed to prevent withholding of tax at the source because of residence, or proof of other acts and statements showing a definite intention to establish residence in the United States, are some of the types of proof which may be presented to

overcome the presumption of nonresidence. An alien whose stay in the United States is limited to a definite period by the immigration laws may not, in the absence of exceptional circumstances, become a resident for tax purposes. Recently, the Bureau of Internal Revenue ruled that the extensions of a temporary visa issued in October, 1938, and held by an individual who planned to return to his country at the end of the war, were not circumstances of a kind to qualify the individual as a resident. In acquiring the status of a resident, it appears not to be necessary for an alien to be domiciled in this country. Once residence is established, mere intention to leave the country will not terminate the resident status and the alien will be considered a resident for the remainder of his stay in the United States.

Resident aliens are in general taxed the same as United States citizens—that is, on incomes from sources both within and without the United States, and at the same rates.

In taxing nonresident alien individuals, the tax law divides them into two general classes: (a) those not engaged in trade or business within the United States and not having an office or place of business therein, and (b) those who are engaged in trade or business within the United States or have an office or place of business therein. The first class in turn is divided into two groups, i.e. those individuals with not more than \$24,000 gross amount of taxable income from sources

within the United States, and those with more than \$24,000 gross amount of taxable income from sources within the United States.

What constitutes being engaged in trade or business in this country or having an office or place of business therein, is a question to be decided by the facts in a particular case. A nonresident partner is considered as engaged in trade or business within the United States or as having an office or place of business therein, if the partnership of which he is a member is so engaged or has such an office. Similarly, if a nonresident alien individual performs personal services within the United States at any time within a taxable year, such activities constitute being engaged in a trade or business. However, a nonresident alien individual temporarily in this country may perform personal services on behalf of other nonresidents not engaged in trade or business within this country, and such individual will not be considered as being engaged in a trade or business, provided his compensation does not exceed \$3,000 while he is here, and his stay during any taxable year does not exceed a total of 90 days.

Section 19.231-1 of Regulations 103 defines the term "office or place of business" as a place for the regular transaction of business excluding a place where casual or incidental transactions might be or are effected. In I.T.3260, C.B. 1939-1, the Bureau of Internal Revenue ruled that the renting in the United States of an office which is occupied by an assistant secretary, whose only duties are to receive dividends and interest from securities purchased by foreign corporations through resident brokers, such securities being held by local banks as custodians, does not constitute being engaged in a trade or business within the United States or having an office or

place of business therein. Section 211(b) applicable to nonresident alien individuals, states that the phrase "engaged in trade or business within the United States" does not include the effecting of transactions in the United States in stocks, securities or commodities through a resident broker, commission agent or custodian, which statement is equally applicable to foreign corporations.

Taxable income of nonresident alien individuals and foreign corporations with no United States business or office is restricted in part to that defined in Section 119 as income from sources within the United States, a subject which might well deserve an article by itself. Dividends from domestic corporations, interest and royalties may for the purpose of this article be passed over without comment. A few of the more important points to accountants must, however, be set forth. Compensation for personal services performed in the United States constitutes income from sources therein except that if a nonresident alien is temporarily present in this country not exceeding a total of 90 days during a taxable year, he may receive up to \$3,000 in compensation for services performed as an employee of a nonresident individual, partnership or foreign corporation not engaged in trade or business within the United States, and such income will not be deemed as being income from sources within the United States. The gain from the sale of personal property *purchased* is attributable to the place where the property is sold. An exception to this is in the case of personal property purchased in a possession of the United States; the gain on such property sold within the United States is treated as being earned partly within and partly without the United States. The gain from the sale of personal property *produced* in whole or in part within

the United States and sold without the United States, is treated as earned partly within and partly without the United States. This is likewise true in the case of personal property produced in whole or in part without and sold within the United States. Gains from the sale of real property are income from sources within the United States, if the real property is located in the United States. Dividends received from a foreign corporation are treated as income derived partly from sources within the United States and partly from sources without the United States, depending on the source of the corporate gross income.

Nonresident Aliens

The income upon which a nonresident alien individual with no United States business or office is taxable is described in Section 211(a) which reads in part as follows:

"upon the amount received * * * from sources within the United States as interest (except interest on deposits with persons carrying on the banking business) dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits and income."

To be taxable, in addition to being from sources within the United States as determined in Section 119, income must also be of a character itemized or described in Section 211(a). This section has been interpreted to exclude as nontaxable income, gains from the sale within the United States of stocks, securities or commodities, as well as gains from the sale within the United States of real or other personal property. Other items of income from United States sources would also be

nontaxable if not enumerated in this Section.

Another feature with respect to taxing nonresident alien individuals with no United States business or office and gross incomes of less than \$24,000 is that they are taxed on gross income, being permitted no deductions for expenses nor the personal exemption credit.

With the possible exception of those residing in Canada or Sweden, the law treats most nonresident alien individuals with no United States business or office and with gross incomes of not more than \$24,000, much more severely than American citizens or residents. The tax rate applicable to the taxable income of such nonresident alien individuals is a flat 16½%, which, as hereinbefore stated, is imposed upon gross income. American citizens and resident aliens, on net incomes of less than \$4,000, pay a maximum tax rate of only 4.4%. Citizens and residents, in addition to being permitted deductions for expenses, etc. are also permitted personal exemptions and other credits against income thus on smaller incomes, the nonresident alien individual with no United States business or office, pays a much greater amount of tax than is paid by a citizen or resident on the same amount of income. However, the nonresident alien individual with no United States business or office, does not have to pay a tax upon gains arising from the sale of stocks and securities or other personal and real property. This, however, is of small consequence to most nonresident alien individuals, who as a class have few transactions of this nature.

A nonresident alien individual with no United States business or office is not required to file a tax return if the tax due by him has been fully withheld at the source. However, if such an individual has

gross income from United States sources of more than \$24,000, unless he resides in Canada he is obliged to file a tax return and pay a tax at the same rates as are paid by citizens and residents of the United States. This return is required because of the possibility that such a nonresident alien, by having tax withheld from his income at the flat rate of 16½%, would pay less tax than a United States citizen or resident would pay on the same amount of income. Swedish residents and subjects residing in foreign countries however are not obliged to pay more than 10% on dividends received by them because of a treaty. Even if the tax at the regular normal and surtax rates plus defense tax computed on net income is less than 16½% of the gross income, the larger amount must be paid.

The income upon which such a nonresident alien individual with a gross income of more than \$24,000 is taxed is that enumerated in Section 211(a) *supra*, which excludes capital gains from stocks and securities sold in the United States as well as gains from the sale of real and other personal property. Such an individual also has other advantages in that he is permitted to deduct expenses if and to the extent they are allocable to taxable gross income from sources within the United States and, in addition, is also permitted to deduct so-called "charitable contributions" to the same extent as a United States citizen. He may also deduct, as a credit against income, a personal exemption of \$800 (regardless of marital status). As a prerequisite to the granting of these deductions and credits, a true and correct tax return must be filed. If no such return is filed, tax is imposed on gross income.

As an example of what is con-

sidered a "true and accurate return", the following case is of interest. In *Gladstone Company Limited, Petitioner vs. Commissioner of Internal Revenue*, 35 B.T.A. 764, the facts show that the company was organized under the laws of Newfoundland and for the year 1931 had failed to file an income tax return, although required by law to do so. In 1933, a Revenue Agent, being advised by the company that no return had been filed by it, prepared and filed a return on August 7, 1933. On December 7, 1933, the corporation on its own behalf, filed a tax return, deducting on the face thereof a certain item, the details of which were to be shown in a separate schedule. This schedule was not filled in. The Board, three members dissenting, held that because this schedule had not been completed, a true and accurate return of the total income of the foreign corporation had not been filed in compliance with the statute, and consequently the deduction taken on the face of the return was not allowable and tax was assessed without the benefit of this deduction.

The income upon which a nonresident alien individual engaged in trade or business in this country or having an office or place of business herein, is taxable is not confined to the items enumerated in Section 211(a), which section determines the taxable income of a nonresident alien with no United States business or office. The income of a nonresident alien individual doing business in this country or having an office or place of business herein, is that described in Section 119, as income from sources within the United States, less allowable deductions and credits. Income from sources within the United States as described in Section 119 includes gains from stocks, securities and other property sold in this country. The deductions

permitted are for those expenses connected with the production of taxable income and as a group include practically all the allowable deductions permitted a United States citizen or resident. In addition, losses not connected with a trade or business, if incurred in a transaction entered into for profit, and losses, the result of a casualty (provided the damaged property was situated in the United States), are also permitted to be deducted from gross income.

As is the case with other non-residents required to file returns, deductions and credits are allowable only if a true and correct tax return is filed.

The tax rates applicable to the income of a nonresident alien with a United States business or office, are the same normal and surtax rates plus defense tax, that are applicable to United States citizens and residents. As to the credits against income, such a nonresident is entitled to the credits against income to which a citizen or resident is entitled with the exception that regardless of marital status, the personal exemption may not exceed \$800.

Credits against tax for taxes paid to foreign countries are not permitted to nonresident aliens in this class yet the privilege of carrying forward net operating losses into the two succeeding years is available.

If a nonresident alien individual with a United States business or office utilizes the services of an agent in this country, it is the duty of such agent to see that a tax return is filed on behalf of his principal, and that whatever tax is due is paid. However, those acting in a custodian capacity, collecting income and performing other duties occasioned by that relationship, and those who sell securities upon special instructions, are not deemed by reason of such

acts to be agents of the nonresident alien and responsible for the filing of tax returns and payment of tax.

Foreign Corporations

Foreign corporations, like non-resident alien individuals, are divided into two general classes for purposes of Federal income tax: i.e. nonresident foreign corporations, defined as those not engaged in trade or business within the United States and not having an office or place of business therein; and resident foreign corporations, defined as those engaged in trade or business within the United States or having an office or place of business therein.

Whether or not a foreign corporation is engaged in trade or business within the United States or has an office or place of business therein depends upon the facts in a particular case, and what was stated previously with respect to nonresident alien individuals in this connection is equally applicable to corporations.

Nonresident foreign corporations are treated the same as nonresident alien individuals with no United States business or office, as to the character of the income which is taxable and as to the fact that the income taxed is the gross amount with no deductions or credits allowed. Section 231(a) enumerates the taxable income of a nonresident foreign corporation and it is worded practically the same as section 211-(a), covering taxable income of nonresident alien individuals with no United States business or office. Consequently, as with such individuals, gains from the sale within the United States of stocks, securities or other property, are not taxable to nonresident foreign corporations.

Except for Canadian and Swedish corporations the basic rate of tax payable by a nonresident foreign corporation is 15%, which under the

Revenue Act of 1940 is retroactive to January 1, 1940 and is applicable to all types of income. Previous Revenue Acts, it will be recalled, taxed dividends at the rate of 10%. The 15% basic rate is, for the five year period ending December 31, 1944, to be increased by 10% thereof, constituting the defense tax, making the total tax rate 16½%. This rate remains the same regardless of the amount of taxable income received.

Resident foreign corporations are treated differently from nonresident foreign corporations. To begin with, taxable income from United States sources is determined by Section 119, Section 231(a), not being applicable. Section 119 includes as income, gains from the sale in the United States of stocks, securities and other property. A resident foreign corporation is not taxable on the entire amount of the dividends received from domestic corporations, but is permitted, like a domestic corporation, to take as a credit 85% of such dividends, such credit, however, not to exceed 85% of the net income. Unlike a nonresident foreign corporation, it is not taxed upon gross income, but is permitted the same deductions from income as are allowed a domestic corporation. The deductions are allowable only if and to the extent they are connected with income from sources within the United States, including a ratable part of any expense, loss or other deduction applicable to income from sources both within and without the United States, but which cannot be definitely allocated to some item or class of gross income. The Board of Tax Appeals in the *London & Lancashire Insurance Company* case, 34 B.T.A. 295, held that in determining the proper ratio for apportioning unallocable expenses applicable to both foreign and domestic income, incurred by the insurance company in its home office, tax exempt Ameri-

can interest and dividends should not be included as part of the gross income from United States sources, but nevertheless, should be included in the total gross income from all sources. This decision allows expenses allocable to taxable American income only.

In addition to the above deductions, a resident foreign corporation may deduct contributions made to and for the use of domestic institutions, whether or not connected with its taxable income. Such contributions however, may not exceed 5% of the net taxable income of the corporation computed without this deduction.

It should be noted here that, as explained previously in the case of nonresident alien individuals, the allowable deductions from income are permitted only if a true and accurate return is filed.

The normal tax rate, including the defense tax, applicable to a resident foreign corporation is 24%, regardless of the amount of income of the corporation. Unlike a domestic corporation, the resident foreign corporation is not permitted to pay a lesser normal tax when its income is less than \$25,000. Because of the fact that resident foreign corporations are engaged in trade or business within the United States or have an office or place of business therein, they are subject to capital stock and declared value excess profits taxes, and also to the new excess profits tax as prescribed in the Second Revenue Act of 1940. However, they may or may not be subject to the tax on the improper accumulation of surplus under Section 102, depending upon circumstances. For example, if a resident foreign corporation had a majority of its gross income from foreign sources for the three year period preceding the one in which the dividend was declared, such dividend

would not be taxable to nonresident stockholders of this corporation and so, if a resident foreign corporation had only nonresident alien individual or foreign corporate stockholders, it would not be subject to Section 102 tax regardless of the extent to which it accumulated surplus.

Resident foreign corporations are also entitled to the privilege of carrying forward into the succeeding two years net operating losses for taxable years beginning on or after January 1, 1939.

Withholding of Tax at the Source

The law provides that the tax due by nonresident alien individuals and foreign corporations not engaged in trade or business in the United States and having no office or place of business therein shall be withheld at the source. No withholding is required in the case of a resident foreign corporation; i.e. a foreign corporation doing business in this country or having an office herein. On the other hand, withholding is required on the income payable to nonresident alien individuals engaged in trade or business or having an office in this country. Withholding is also required from income payable to a nonresident alien fiduciary, even though the beneficiary of the estate or trust is a resident or citizen of the United States. In general, a withholding agent is described as any one having the receipt and disposal of income taxable to nonresidents, and all persons so acting are obliged by law to withhold tax that is due. The term withholding agent includes a resident or domestic fiduciary who has control of the income payable to nonresident beneficiaries.

The Revenue Act of 1940 provides for withholding as follows. Except with respect to taxable income received by residents of Canada and Sweden, the rate is 16½% on all types of income whether received by individuals or corporations. As the

result of treaties with Canada and Sweden, the rate applicable to Canadian resident individuals is 5% on all types of income and the rate applicable to Canadian corporations, is 5% on dividends and 16½% on other income. As to Swedish residents, both individual and corporate, the rate on dividends is 10% and on other income 16½%.

The Revenue Act of 1940 increased the rates of tax applicable to nonresident alien individuals and foreign corporations, which increase, while retroactive to January 1, 1940, was not applied until June 26, 1940 the day following the enactment of the First Revenue Act of 1940. Consequently, many foreign taxpayers will not have had the tax for 1940 fully withheld at the source.

The income upon which the tax is withheld is that prescribed by the law as being taxable and of a fixed or determinable annual or periodical character. Where income is not of such nature, withholding is not required. It has been held that withholding was not required from an art prize won by a nonresident alien individual, nor from race track winnings of such an individual. Withholding is required from taxable dividends in stock or other property, and also is required in full from income regardless of a claim that such income is only partially taxable, as is often the case with dividends of mining companies. If it is later proved that only part of a dividend is taxable, the remedy of the taxpayer for the excess tax withheld is through a claim for refund, accompanied by a tax return. No withholding is required from interest received at the time a bond is sold nor is any withholding required from coupons of bonds issued prior to January 1, 1934, the bond indenture of which contains what is known as an unlimited tax free covenant clause.

The New York Certified Public Accountant

The following schedule may show more clearly the applicable withholding rates under the new law:

Type of Income	Nonresident Aliens (individuals, fiduciaries and partnerships)			Foreign Corporations		
	Canadian Residents	Swedish Residents*	Other Residents	Canadian Corpora- tions	Swedish Corpora- tions	Other Corpora- tions
Dividends	5%	10%	16½%	5%	10%	16½%
Other income	5%	16½%	16½%	16½%	16½%	16½%

(For the sake of simplicity, no reference is made here to the variations in withholding rates on coupons caused by certain tax free covenant clauses in bond indentures.)

Where taxpayers subject to withholding and having gross incomes of less than \$24,000 have had the entire tax due by them withheld at the source, they are not required to file tax returns. In the event that tax due for the entire year has not been fully withheld at the source, it is necessary that the taxpayers file returns reporting the income upon which full tax was not with-

held and pay the balance of tax due. As mentioned above, the first Revenue Act of 1940 retroactively increased the rate of tax applicable to nonresident taxpayers, but since withholding at the increased rates did not start until June 26, 1940, it will be necessary in many cases for nonresident aliens to file returns and pay the balance of tax due for the calendar year 1940.

* The benefits of the Tax Convention with Sweden are available to Swedish subjects residing in foreign countries other than Sweden, as well as to subjects and others residing in Sweden.

Do Tax Considerations Stymie Changes to a Natural Business Year?

By NICHOLAS SALVATORE, C.P.A.

DURING the past few years many enterprises have adopted their respective natural business year as the basis for their annual accounting. Other business men and corporate executives favor such a change because of the resulting economic and accounting advantages, but many have hesitated to change from their present calendar or fiscal year bases because of the income tax inequities which often result from such a change.

What is a natural business year?:

The natural business year of an enterprise is that consecutive twelve months period which ends at a time when the business activities are at their lowest point in the annual cycle. The end of such a period marks the time when purchase, sales and production commitments are least complex. The twelve month span of the natural business year varies, of course, with each type of enterprise. Such span is gauged, in the final analysis, by the periods of greatest and lowest consumer demands for the products of the particular business or industry.

Advantages of accounting on a natural business year basis:

The business and accounting advantages resulting from keeping the books of account on a natural year basis are numerous. As sales activities and production are at their lowest and often negligible at the end of a natural business year, the normal activities of the production and accounting departments are appreciably curtailed. Such a condition results in less expense, greater effi-

ciency, and more accuracy in taking inventory, closing the books of account, and preparing the financial statements.

The taking of an accurate physical inventory is one of the important factors in the preparation of a manufacturing or trading enterprise's balance sheet and related statements of profit and loss and surplus, in order that these will fairly present its position at such date and the results of its operations for the period then ended. The inventory at the end of a natural business year, as already pointed out, is at its lowest in the year. The activities of the personnel in the production department at such time are likewise at their lowest. The experienced factory foremen, storemen, stockmen and others, having the time and knowing their stock, can take a more accurate physical inventory and in less time than extra "green" help, which often has to be hired if inventory taking comes at a time when production activities approximate their normal level. The lower the inventory in quantity, the lesser the likelihood of error. In addition, when production and sales are negligible or at a standstill, there is little or no movement of stocks, so that there is less possibility of the duplication or omission of items.

The accounting staff at the end of a natural business year is comparatively free to devote all of its time to the task of closing. Whereas, when the time of closing occurs at a more active period, the normal activities of the accounting department often preclude its members from concentrating on this phase, and necessitate the hiring of costly un-

trained help to facilitate the yearly closing.

Normally, at the end of a natural business year, the financial statement of an enterprise reveals its most liquid position because the inventories, receivables, and current liabilities are then usually at their lowest. A business enterprise which submits annual statements on the basis of a natural business year therefore presents its simplest picture to credit grantors, past or prospective.

The best testimonial to the desirability of accounting on a natural business year basis is sponsorship given to such a movement in recent years by national trade, professional, and credit organizations.

The natural business year movement has been supported by public accountants primarily because of the advantages accruing to clients from its adoption. But such a movement would also ultimately spread out the accounting year ends, thereby appreciably diminishing the number of nerve-racking days that most public accountants now experience during the hectic months of January, February and March, and equalizing the accountant's work throughout the year by shaving off the peaks and filling in the valleys.

This movement should likewise find favor with the tax administration authorities, both federal and state, for it would spread the task of collection, review and audit of tax returns.

Despite the fact that most business executives recognize that accounting on a natural business year is far more advantageous and desirable, many still retain a calendar year basis, or a fiscal year basis other than their natural business year, because of the belief that the present tax laws compel them to do so. Others have studied the effect of making such a change and have preferred to remain on their present ac-

counting basis rather than become subject to the tax inequities that often result.

Tax requirements to effect a change:

The tax requirements to effect a change to a natural business year are quite simple. The law provides that if a taxpayer changes his accounting period from one fiscal year to another, or from a fiscal year to a calendar year, or vice versa, the net income shall, with the approval of the Commissioner of Internal Revenue, be computed on the basis of such new accounting period (I.R.C. Sec. 46). It further provides that a separate return shall be made for the following short periods of less than twelve months: (a) between the close of the former fiscal year and the date designated as the close of the new fiscal year, (b) between the close of the last fiscal year for which a return was made and the following calendar year, or (c) between the close of the last calendar year for which a return was made and the date designated as the close of the new fiscal year, depending on the type of change effected by the taxpayer (I.R.C. Sec. 47).

The regulations provide that if a taxpayer changes his accounting period he shall, prior to the expiration of thirty days from the close of the proposed period for which a return would be required to effect the change, furnish to the Collector, for transmission to the Commissioner, the information required on Form 1128 (Regulations 103 Sec. 19.46-1).

The information to be furnished on Form 1128 includes the name and address of the taxpayer, whether the business is conducted as an individual, partnership or corporation, and if a corporation, the date of incorporation, the date business commenced, the dates upon which the books of account were opened and

closed each year for the past four years, the dates upon which the taxable year began and ended as shown on returns filed for the past four years, and the reason why the change in accounting period is desired. Probably the best reason that can be advanced for a change is the taxpayer's desire to have the accounting period coincide with the natural business year.

The requirements with respect to the filing of a separate return for a period of less than twelve months and the payment of tax for the short period are the same as for the filing of a return for the full twelve months and the payment of tax for a full taxable year, that is, the separate short return is due on or before the fifteenth day of the third month following the close of the new taxable period, and the tax is payable in one sum or in equal quarterly installments.

However, where a separate return is made on account of a change in the accounting period, except in the case of corporations, the net income computed on the basis of the period for which the separate return is made must be placed on an annual basis. The tax due thereon is such part of the tax computed on such annual basis as the number of months in such short period is of twelve months.

Tax consequences resulting from a change and suggested tax amendments:

The comparatively simple and somewhat mechanical steps necessary to effect a change in a tax accounting year are no deterrent to taxpayers desirous of making a change. The factor which often forces taxpayers to abandon a contemplated change of accounting year is the added tax burden that sometimes results. The change may entail a proportionately greater tax liability or it may involve the loss

of the beneficial allowance of certain income tax deductions or net loss carry overs. Where a tax advantage results from a change, it is merely an additional inducement to make the change.

An illustration of how the tax consequences forced a taxpayer to forego a contemplated change is the case of a retail organization which has been accounting on a fiscal year basis ended January 31st. In the Spring of 1939, its management had under consideration a change to a natural business year ending July 31, 1939. As most retail businesses operate at a loss or at a negligible profit during the spring season period from February 1 to July 31 inclusive, similarly, the operations of this taxpayer for such period were at a loss.

Under the law, if a change were made in this case a separate return would have been necessary for the short period, February 1 to July 31, 1939 inclusive. As its operations for the period were at a loss, no tax liability would have been incurred for such period, but no beneficial allowance could be had, for tax purposes, of this excess of allowable deductions over taxable income, whereas, if no change were made, the loss of the 1939 spring season could be applied against the profit of the 1939 Fall season covering the period from August 1, 1939 to January 31, 1940.

The taxpayer likewise could not avail itself of the benefit of the net operating loss carry-over provision introduced into the Code by the 1939 Act because, by its provisions, the net operating loss deduction was first made available in a taxable year beginning after December 31, 1939. The loss of the short period from February 1 to July 31, 1939 could not be carried into the succeeding tax year of the taxpayer as that year would have commenced on August 1, 1939.

The management of this organization, upon being apprised of the tax consequences, shelved, for the year 1939, the proposition of changing the fiscal year; but it is well to point out that the management merely deferred, for one year, the making of such a change and a decided tax advantage is expected.

The operations of the 1940 Spring season were at a loss and, as the change was made in 1940, a return was due for the short period, February 1 to July 31, 1940 inclusive; assuming that the law with respect to the carrying forward of operating net losses will remain unchanged, the return for the year commencing August 1, 1940 will include as a deduction the net operating loss for the six months ended July 31, 1940. The effect of this is that the taxpayer will, in its first full new fiscal year, be able to offset the losses of the Spring seasons of 1940 and 1941 (February 1, 1940 to July 31, 1940 and February 1, 1941 to July 31, 1941), against the anticipated profits of the 1940 Fall season (August 1, 1940 to January 31, 1941), with a possible carry-over to the fiscal year commencing August 1, 1941 of any operating loss resulting in the fiscal year ending July 31, 1941. This case illustrates a situation where by proper planning and timing, a "stymie" may become a "birdie".

Another example of a tax burden which would preclude a change in natural business year is the case of a corporation on a calendar year basis whose natural business year ends on March 31st and sixty per cent. of whose gross income for the year is derived from the operations of the three months ended March 31st. If that corporation were to change its accounting period from a calendar year to a fiscal year ended March 31st, it is evident that a serious tax disadvantage would ensue. The corporation would be required to file a

return of income for the short period, the three months ended March 31st, the period of its greatest income and pay a tax thereon. It would not have the opportunity of offsetting, against the high income of this short period, the losses of the succeeding nine months. This would be the situation in all cases where the short period is the period of greatest earnings. It would not matter in which year a change were made, for so long as the three months ended March 31st continued to be the period of greatest profit, a change would necessarily result in an increased tax burden. The economic and business advantages to be derived from a change under such circumstances probably would not warrant the payment of the additional tax.

To remedy this and like situations, an amendment to the Internal Revenue Code has been suggested to provide that, in the case of a return for a period of less than twelve months, there be added to the net income for the short period the net income for remainder of the full twelve months' period (that is adding the income or deducting the loss of the months succeeding the end of the short period), and that the tax be computed on the basis of that twelve months' net income. The amount of tax payable for the short period would then be such portion of the tax on the twelve months' net income as the number of months in the short period is to twelve months. This seems to be an equitable remedy and the only cost involved to the taxpayer would be that of an interim closing of the books of account, at the end of what would have been its tax accounting year, if no change were made. As far as the Treasury Department is concerned, such an amendment should not appreciably affect its revenue as the tax collectible on this basis would approximate the tax that would be

Do Tax Considerations Stymie Changes to a Natural Business Year?

collected if no change in the tax accounting year were made.

Another consideration, although limited in scope, is the item of capital gains and losses. Under our tax law, these are classified into long-term or short-term. The predominance in amount of short-term gains in the short period may be a motivating factor in postponing a change, particularly where, in the months immediately succeeding the short period, short term losses were anticipated, which could be offset against the short term gains, if no change in the tax accounting period were made.

In the case of individual taxpayers, who are required by law to place the income for the short period on an annual basis, the usual deterrent is that the tax on the net income for the short period is proportionately in excess of the full year's tax. To eliminate this barrier, and to permit individual taxpayers to make a change in a tax accounting period on an equitable basis, it has been suggested that there be deleted from the Code the provision requiring, in the case of taxpayers other than corporations, that the income for the short period be placed on an annual basis. However, if Congress does not see fit to make this a permanent change, it is suggested that for a period of, say, one year, individual taxpayers who wish to change to a natural business year be permitted to do so without being required to place their net income for the short period on an annual basis.

Another factor that might be of serious consequence is the effect that a change in the tax accounting period for federal income tax purposes might have on the measure of state franchise taxes payable. For example, for New York State franchise tax purposes, the law provides that if a corporation has been permitted to change the period for

which it shall make its report, it shall be taxed upon a base measured by the entire net income which has not been used or included in measuring a franchise tax to this state as though the entire net income had been earned within one year. (Article 9A, Section 214 (8) of the Tax Law). This section provides that "If any corporation has been permitted to change the period for which it shall make its report, it shall be taxed upon a base measured by the entire net income which has not been used or included in measuring a franchise tax to this state as though the entire net income had been earned within one year." So that where a corporation changes from a calendar year to a fiscal year basis ending, for example, on March 31st, the first return, made on Form 3 I.T. on the new basis, will show the net income reported to the Federal Government for the three months' period ending March 31st, plus the income of the calendar year next preceding. Similarly, the segregation of assets reported would also give effect to the fifteen months' period. Depending, of course, upon what form the change in the accounting period takes, the measure of the franchise tax payable might be more or less than twelve months' income and as much as twenty-three months' income.

In the case of a going concern, where the measure of the franchise tax would be more than twelve months' income, the resulting increase in franchise tax payable would be tantamount to a penalty. However, where, as a result of the change, the measure of franchise tax payable would be less than twelve months' income, it would be but an additional motivating factor to make a change.

Corporate taxpayers of other states must also consider the state and local tax effects for they may

well be the primary reason for postponing or abandoning a proposed change.

Another important factor, that may dissuade corporations considering a change in their tax accounting year, is the new excess profits tax. The Excess Profits Tax Act of 1940 provides that, if the taxable year is a period of less than twelve months, the excess profits net income shall be placed on an annual basis. The excess profits tax payable shall be such part of the tax computed on such annual basis as the number of days in the taxable year is of the number of days in the twelve months ending with the close of the taxable year (I.R.C. Sec. 711(a)(3)).

If the income for the short period is not ratably comparable with earnings for a full year, an unfair and burdensome tax liability will result. Here again the previously suggested amendment to the Code would provide equitable relief.

Conclusions:

It is not to be inferred that these tax disadvantages, or others that might result, necessarily preclude a change to a natural business year, for, to borrow a term from golf, the correct "timing of the swing" often accomplishes the desired result. Therefore, taxpayers who wish to change their accounting period to their natural business year should study the tax effects of the proposed change each year in the light of both their operating results and the revenue laws then in effect, with a view toward so timing the change that it occurs at a period when the resulting federal and state tax consequences are negligible or advantageous. In the meantime, interested taxpayers, tax practitioners, the trade, credit and accounting organizations should foster amendments to the Code along the lines suggested, permitting changes in accounting periods on a basis equitable to taxpayers.

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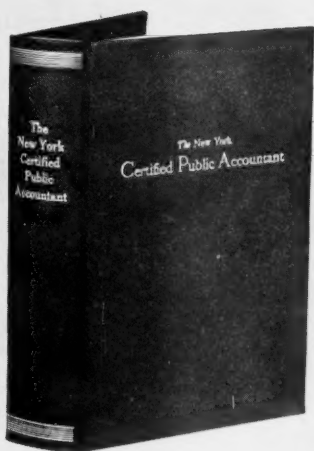
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